Government and Business

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Preface to the Third Edition

The new edition of *Government and Business* is designed to serve the needs of courses in business administration, economics, and political science on the legal framework of business, government and business, and public policy toward business. Its purpose is to explain the many ways in which business and economic life are shaped and directed by government—to promote general economic well-being, to enhance business incomes of politically important groups, and to strengthen national defense.

The book presents the legal framework within which business is conducted. It then traces the evolution of public policy toward business. The order of arrangement considers first the efforts of government to create and maintain competition in the various fields of business; then the exceptions which have been made in our basic policy of competition; and finally the positive forms of control which have been adopted in place of competition.

The present volume seeks to present the latest trends and developments in the regulation and control of business. New topics—such as government and small business and public policies toward agriculture—are included. Other topics are expanded. The book treats more fully the economic principles and concepts which underlie legal regulation.

In the new edition, I have united all of the material on the Sherman Act and conspiracies in one chapter and that on mergers in another chapter. Important conclusions of the Attorney General's National Committee to Study the Antitrust Laws are included. There is a new treatment of the Clayton and Robinson-Patman Acts which considers in order each main provision and its application.

The material on public utility regulation and control as practiced by the federal commissions has been rewritten and brought up-to-date. New information on public power and investor-owned utilities is included.

In the chapter on regulation of the general level of economic activity, I have sought to present a unified analysis of monetary-fiscal measures *and* antitrust law policy designed to promote high-level employment, economic growth, and stability.

My work in government and business during the past thirty years has brought me into close association with George J. Stigler, Leland Traywick, Walter Adams, C. D. Edwards, Milton Friedman, Russell Decker, Julius Tolton, Ron H. Wolf, Fritz Machlup, Philip Cartwright, John M. Blair,

E. S. Corwin, William Summers Johnson, Everette MacIntyre, and Walter B. Stults. To these colleagues, especially, I wish to extend my warm gratitude and thanks.

The present edition takes into account the comments and suggestions made by many persons teaching in the field of government and business. They include Professor Robert W. Harbeson, Ralph L. Dewey, Richard Spangler, Shorey Peterson, Eleanor M. Hadley, Marshall R. Colberg, Clinton A. Phillips, William Miernyk, John S. McGee, J. O. McClintic, E. L. Eckles, Lionel Epstein, John E. Elliot, John V. Craven, M. O'Connor, D. Gale Johnson, Benjamin J. Klebaner, Richard Deutsch, H. W. Bohlman, Alfred E. Kahn, W. J. Samuels, Holland Hunter, Rev. James L. Duffy, S.J., Leonard F. Cain, J. Alexander, and J. J. Klos. I greatly appreciate the helpful suggestions which these friends have given.

My thanks are especially due to many persons in government who have kindly conferred with me and have answered numerous questions on the laws which are analyzed in the text. My debt to these persons is much too great for detailed acknowledgment. However, I would like to mention those who have seen the book develop through three editions. They include Senator Henry M. Jackson; Joseph E. Sheehy, Lynn C. Paulson, and Daniel J. Murphy, Federal Trade Commission; Robert A. Bicks, Assistant Attorney General, Antitrust Division, Department of Justice; Dr. Joseph G. Knapp, U.S. Department of Agriculture; A. S. Whiteley, Member, Restrictive Trade Practices Commission, Ottawa, Canada; James E. Newton, Attorney-in-Charge, Securities and Exchange Commission, Seattle; and Walter W. Harris, Attorney-in-Charge, Federal Trade Commission, Seattle.

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I am particularly indebted to my wife Alice Maxwell Mund for her encouragement in undertaking the third revision. Her patience and enthusiasm were important factors in getting the work done.

During the past ten years, I have received many letters from students and teachers who have used the first and second editions. This has been a gratifying experience. I welcome these contacts and cordially invite continuing comments and suggestions.

VERNON A. MUND

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Government and Business

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The Political and Economic Functions of Government

THE APPROACH OF THE PRESENT STUDY

The essential purpose of this book is to give the reader a broad understanding of the many ways in which business and economic life are shaped and directed by government. In developing our analysis, we shall study the action which government takes to promote and enhance the economic well-being of its citizens through measures designed (1) to achieve a growing output of desired goods and services and (2) to provide for a distribution of this income in harmony with the general welfare.

A study of government and business is certain to give rise to critical thinking about the relations of government to business. What is a good economic system—both as to means and as to ends? How much government intervention should there be in the conduct of business? What forms should it take?

It is sometimes said that next to a sound digestion the most important thing for a young man or woman to have upon leaving college is a sound philosophy. A personal philosophy may be defined as a coherent and critical set of ideas with respect to human life and society. The phrase "critical set of ideas" is used to mean ideas and views which are subject to testing and re-examination in the light of reason and evidence. One's philosophy should also include a carefully thought out set of values—that is, criteria for judging what is sound public policy.

The importance of having a workable plan for living arises from the fact that one's personal philosophy, together with the personal philosophies held by other citizens, largely determines the kind of society in which we shall live. Should government take action to dissolve large corporations? What policies should be pursued with respect to mergers? What should government do about oligopoly, basing-point and zone systems of pricing, resale price maintenance, the extension of public power, and industry-wide bargaining by national unions and national associations of employers? Our ideas with respect to these and other problems and the situations in which we find

ourselves determine basically the way in which we shall live and work.

The purpose of the present book is not to give its readers a personal philosophy. It is rather to build up their experiences and factual background in the field of government and business so that they, themselves, will have a broader basis for developing a coherent set of ideas with respect to a desirable economic order, both as to means and as to ends.

DEVELOPMENT OF GOVERNMENT

The regulation of social and economic activity undoubtedly first took form in the rules and regulations established by individual family units engaged in self-sufficient production. Each family had its own plot of ground; and the routines of work, the division of labor, and the sharing of income were administered by the family head. The relations between parents and children, between master and slave, and between the family and property were likewise subject to a system of order and control.

With the development of exchange and commercial activity, family units entered into a growing number of new and complex social relationships. Markets were established, standard weights and measures adopted, and witnesses used to see that buying and selling were conducted openly and fairly. In the establishment of these institutions, certain individuals in the community exercised a leadership in meeting the needs of the group; and in the course of time such leadership assumed a permanence in the form of a centralized authority. This central authority came to be known as *government.*

The rules and customs which various *associations* of people—such as the family, the church, the trade association, and the labor organization—make for themselves can usually be counted upon to provide ordered relations for their own specialized group. When individuals and groups engage in community living, however, a set of rules and ordered relations becomes necessary for the social group. It is here that government arises and intervenes. The growth of private possessions, for example, occasions the need for a central authority to provide protection against theft, a means for settling disputes, and rules for the inheritance of property and the transfer of title. A further need arises in the greedy demands which organized producers make against unorganized consumers. The action of an association of bakers, for example, in agreeing that none shall sell bread below a certain price works an injury to all other citizens in the community. An important task for government in a private enterprise society, accordingly, is that of making "rules of the game" for the conduct of economic activity, so that individuals in seeking their own advantage will produce results which are in accord with the public good.

Government, whether at the local, regional, or national level, is a special form of regulation for maintaining ordered relations in a community. The various types of regulation exercised by government are more vast in their

scope than those of any other human association. The general authority of the state is also unique in that it is legally supreme over all other associations, as well as individuals, in its power to command obedience according to the law.

CONCEPTS OF COMMUNITY, STATE, AND GOVERNMENT

In considering the flow of authority in the process of government, it is desirable to differentiate the concepts of community, state, and government. The essential idea of a *community* is that of a group of people living in a certain area and having common relationships with one another. Thus, a community may be a town, a county, a regional district, or a nation. People live *in* communities, and among the relationships which they typically have with one another are those centering in their buying and selling activities. Within a community various *associations* of people arise for the pursuit of *a* common interest. They include the family, the church, the labor union, and the trade association. The most inclusive and one of the most permanent of all associations in a community is the *state*—either regional or national.

The state may be defined as the political organization (or association) of a group of people living in a defined territory (a community) for the promotion of their common interest. The term "political," it may be noted, is derived from the Greek term *politikos*, which means pertaining to a "city" or to "citizens." In the words of Professor MacIver, "We must definitely declare it [the state] to be an association belonging to the same category as the family or the church. Like these it consists essentially of a group of members organized in a definite way and *therefore* for limited ends."[1]

In viewing the state as an association of people for certain ends, it is usual to define *government* as the agency or instrument of the state—and so of the people. Francis G. Wilson, for example, says that government is "the machinery of the state; it is its lever of social control, and its officers act as agents of the state."[2]

POLITICAL FUNCTIONS OF GOVERNMENT

The functions of government may be classed as (1) political and (2) economic. In summary form, the main political functions are as follows:

The Protection of Persons and Property

A primary political duty of government is to provide members of the community with personal security in their daily lives, with protection to their

[1] R. M. MacIver, *The Modern State* (London, 1926), p. 7.

[2] F. G. Wilson, *The Elements of Modern Politics* (New York, 1936), p. 55.

property, and with defense against unfriendly acts or invasion by foreign states. Defense and war are enormously expensive and demand a tremendous diversion of labor and wealth from other ends. Expense is involved not only in direct military expenditures but also in the social cost of maintaining certain industries by means of tariffs, import quotas, and subsidies in the interest of national security. Large quantities of goods and sums of money are also employed in building up and strengthening neighboring countries for political support in case of war. From a strictly economic point of view, controlled disarmament and the strengthening of the United Nations would make possible a substantial increase in economic well-being.

The Establishment of a Fair and Expeditious System of Justice

To provide a fair and expeditious system of justice, the government carries out its administration of the legal code of the state. The legal code is composed of civil (or private) law and public law. *Civil law* deals with the controversies which arise in the private relations of individuals. Such actions include private disputes over contractual relationships, debts, and property. A large part of the activities of the courts for civil purposes has to do with the private contractual relations of business, and the maintenance and administration of a system of civil law may also be classed as an economic task of government. *Public law*, on the other hand, deals with relations between individuals and the state and defines offenses against the common welfare. Examples of public law include the Sherman Act (1890), the National Labor Relations Act (1935), and the laws against murder, theft, and treason.

The Guarantee and Promotion of Human Rights

The First Amendment of the United States Constitution provides that Congress shall make no law "respecting an establishment of religion, or prohibiting the free exercise thereof" or "abridging the freedom of speech or of the press," or the rights of assembly and petition; the Fifteenth Amendment provides that neither the United States nor any state shall deny any citizen of the right to vote "on account of race, color, or previous condition of servitude." Increasingly, at the present time, the national government is taking steps in a positive way to protect the liberty of religious, racial, and other minority groups against the discriminatory action of other groups and persons.

The Promotion of the General Welfare of the People

The United States Constitution provides that Congress shall have the power to levy and collect taxes for the "general welfare of the United States"; and the individual states themselves have the power—the so-called "police

power"—to promote the health, safety, morals, and general welfare of their citizens. In the exercise of the welfare function, government has engaged in a great variety of pursuits bearing directly on the well-being of the people. Activities which governments render in a cultural way include the establishment and support of public education, libraries, art galleries, museums, and public parks. Governmental services which directly promote social and economic well-being include public health services and social welfare benefits to aged persons, the blind, dependent mothers, indigent persons, and homeless and neglected children.

Other activities in the general welfare group include census taking, weather reporting, safety inspection, fire protection, city planning and zoning, and the maintenance of penal and corrective agencies. Some of the social welfare activities of government designed to ameliorate the conditions of community living are very close to, or also within, the category of economic regulation, for they bear directly upon business and the production of goods and services. Such measures include public housing, minimum wage laws, maximum hour regulations, workmen's compensation, unemployment and old age insurance, reforestation, soil conservation, irrigation, flood control, canal making, and the improvement of harbors and waterways.

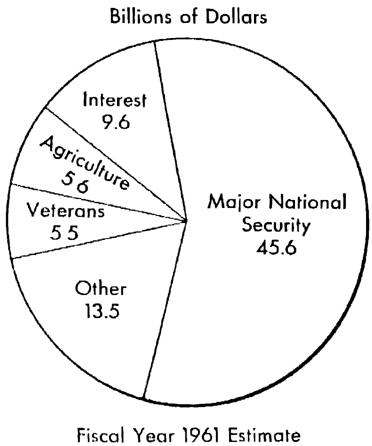


FIGURE 1. Budget Expenditures: Fiscal Year 1961, Estimate. Federal budget expenditures go largely for defense, present and past. Expenditures for major national security programs constitute around 60 percent of the budget. Interest payments, largely the result of public debts incurred during World War II, take about 10 percent; payments to veterans amount to around 6 percent. (Source: Bureau of the Budget)

ECONOMIC FUNCTIONS OF GOVERNMENT

The functions or purposes of government in regulating business are essentially two: (1) to promote the maximum production of goods and services and (2) to provide for a determination of prices and incomes which is in harmony with the public welfare. In fulfilling these functions, government creates and operates a system of economic institutions. Economic institutions are *social arrangements*—such as private property, freedom of contract,

freedom of entry, price competition, price control, and fiscal policy—by means of which business life is organized, directed, conducted, and regulated.

To Promote a Maximum Production of Desired Goods and Services

Adam Smith in *The Wealth of Nations* (1776) declared that a principal object of political economy was that of making the production of goods and services as large as possible. A system of "natural liberty," or freedom of competition, would, he believed, operate to make the produce of labor far greater than it was under the then operating system of mercantilism. He gave little attention to the problem of the distribution of the income produced. His position appears to have been that a larger income for labor could be secured only by increasing the national income. Likewise, James Mill, in his *Elements of Political Economy* (1821), stated that the object of political economy is to ascertain by what means the objects of desire "may be produced with greatest ease and in greatest abundance, and upon these discoveries, when made, to frame a system of rules skillfully adapted to the end."

Today, the common aim of the various economic systems—in the Free World and in the Soviet area—is to achieve a growing output of goods and services. Economic abundance is usually discussed in terms of "gross national product"—the total estimated money value of all goods and services produced in the United States within a specific period. Since 1929, our gross national product, measured in real terms, has been increasing at an average rate of slightly less than 3 percent a year. In order to provide a higher level of living for the American people, as well as increased resources for defense and the "cold war," economic discussion is now centering on whether or not economic growth can be increased to a rate of 5 percent a year or more.

The goal of a high and rising level of production carries with it the corollary of a minimum amount of unemployment. Governmental action is frequently directed toward correcting unemployment and providing employment. In this activity, government seeks to promote production and also to provide incomes for persons idle through no fault of their own.

A further goal related to a high and rising level of production is that of a reasonably stable level of prices. Price stability operates to promote production by encouraging saving. It also reduces excesses in speculative investment and major fluctuations in the business cycle (see Chapter 23).

Important forms of government intervention to promote a high and rising level of production, we shall find, consist of (1) the creation and maintenance of competition, (2) the curbing of monopolistic restrictions, (3) the purposeful use of public expenditures and taxes to influence the level of employment and business activity, (4) the adoption of direct control or public ownership in certain monopolistic industries, (5) the promotion of research and technology, and (6) the development and conservation of natural resources.

To Provide Prices and Incomes in Harmony with the Public Interest

In regulating the conduct of economic activity, government has the further duty of providing methods for the determination of prices and incomes—that is, for the sharing of the goods and services produced in the nation. Basically, incomes may be determined (1) equally, (2) in accordance with people's needs, or (3) upon the basis of the economic value (importance) of one's productivity and the productivity of his property.

For the most part, public policy in the United States seeks to provide for the determination of prices and incomes in accordance with the economic law of value, as established under conditions of competition. Government, therefore, intervenes in business to (1) maintain the principles of price competition and freedom of entry, (2) prevent monopoly, and (3) impose public price fixing by commissions when monopoly is accepted.

The general principle usually followed by government with respect to the determination of prices and incomes is that of eliminating, as far as possible, coercion, compulsion, fraud, arbitrariness, cheating, favoritism, monopoly, and discrimination. Such action, it is believed by most citizens, makes for "fair" prices and incomes in line with one's merit or work.

The purpose of democratic government is to promote the well-being of all the people. In the economic sphere, this objective is achieved by performing the two basic economic tasks as explained above. Through the influence of organized interest groups, however, the democratic character of government may be seriously compromised. In many actual cases, government serves as a mechanism or vehicle by which organized producers seek directly to promote their particular business interests. Instead of providing for a maximum production of goods, government may assist organized producers in reducing and restricting market supplies (tariffs, import quotas, interstate trade barriers, and price assistance programs in agriculture). Instead of providing for competition to moderate the extreme demands of various sellers, government may tolerate or authorize monopolistic efforts by industry groups to get a larger share of the national output. A principal and continuing problem of citizens collectively—of the nation as a whole—is that of ascertaining the "common interest" and making it dominant over all others in the struggle of organized producers for larger shares of income.

THE WELFARE STATE

Government not only takes action to provide for the distribution of the social income, but also for its redistribution by means of taxation. In this activity, it takes money from those who can afford it and gives it to the poorer classes in various ways as grants and subsidies. Why, it may be asked, does government go to all this trouble? Why does it not endeavor to provide for an equitable distribution in the first instance?

Government action to redistribute existing income is supported by those who believe that a reform or modification of established methods for determining prices and incomes is certain to be slow and politically difficult, because of strong opposition from vested interests. Sharp differences of opinion also exist on the remedial measures which should be adopted to improve the working of our economic system. Heavy taxation, on the other

FIGURE 2. Symbol of Justice. The traditional formula of economic justice has been "to each according to his work"—that is, according to the economic value of one's productivity and the productivity of one's property. Today, in the welfare state concept, consideration is being given to the formula "to each according to his needs." Picture from Collegio del Cambio, medieval exchange market in Perugia, Italy, painted A.D. 1499–1500.

hand, has become quite well established as a result of wars and depressions, and it is believed that taxation can be readily employed to promote "welfare for all."

A government which seeks to provide every citizen with minimum guarantees for material welfare—medical care, education, employment, housing, and pensions—has come to be called by its supporters the "welfare state," and, by its critics, the "Santa Claus state" and the "transfer-payment state." The basic idea underlying the welfare state is the view that each individual is a human being and, as such, is entitled to a fair share of welfare, even though he does not have the necessary financial resources to secure it. Slogans expressing this idea are "fair shares for all," "welfare for all," and "a good life for all."

As expressed by the British Labour Party, "The first principle of the Labour Party—in significant contrast with those of the Capitalist System, whether expressed by the Liberal or by the Conservative Party—is the securing to every member of the community, in good times and bad alike (and not only to the strong and able, the well-born or the fortunate), of all the requisites of healthy life and worthy citizenship."

In a similar line of thought, the Italian legal writer, del Vecchio, declares that out of consideration for social continuity and the development of human personality, the classical formulas "To each according to his merit" and "To each according to his work" must be modified in favor of "To each according to his needs".[3]

THE GREAT EXPANSION IN SOCIAL SERVICES

During the prolonged depression which began in 1929, the social services provided by government were enormously increased. President Roosevelt proposed that national goals should include "freedom from want" and "freedom from fear." One-third of the people, he declared, were "ill housed, ill clothed, and ill fed." Under his leadership the national Congress enacted legislation providing for low-cost public housing, minimum wages, maximum hours, social security, and agricultural subsidies. At the present time, it is the desire of many individuals and social groups that the services of government be further increased to provide universal medical, dental, and nursing care, as well as a greatly expanded program of public housing.[4]

Growth of the social welfare functions of government raises the question of how far government should go in providing for the material well-being of its citizens. If the government provides care "from the womb to the tomb," some persons ask, will not individual initiative, ambition, and resourcefulness be dulled? Their point of view is that if the government increasingly offers public assistance, people will accept the crutch and lean on government the rest of their lives. "Too much government," it is said, "means little men." It is only by struggle, adversity, and victory, many believe, that man gains self-reliance, self-confidence, and stature.

A further problem created by the social objective of welfare for all is the effect of heavy taxation, required to finance it, upon the initiative of individuals engaged in productive activity. In our present economy, financial gain is the strongest and most effective incentive for getting people to work hard, assume risks, and undertake responsibility. Without the "carrot" of money

[3] Giorgio del Vecchio, *Justice* (New York, 1953), pp. 142, 147–148.

[4] Congress appears to have a free hand to use public funds to promote the general welfare as it sees fit. In *Massachusetts and Frothingham* v. *Mellon*, 262 U.S. 447 (1923), and again in *U.S.* v. *Butler*, 297 U.S. 1 (1936), the Supreme Court held in principle that Congress may appropriate public money and authorize its use by administrative agencies for any social welfare purpose.

gain, many believe, individuals will be discouraged in preparing and training for executive positions, in giving managerial work the best of their ability, and in investing capital in new and uncertain ventures. If private initiative and enterprise are overburdened by taxation, it is said, government will sooner or later be required to assume ownership and control over an increased sector of the economy.

Basically, it is also reasoned, individual well-being is not something which can be given to people. It is rather a condition which comes through individual effort and enterprise. In this process, the individual himself has primary responsibility for achieving a harmonious, disciplined life. The family, the church, and other associations also have a part to play. Larger, more powerful groups, such as the state, should not take over functions which smaller groups can and will perform adequately. The idea that government should have only an auxiliary or subsidiary role in the realization of welfare, for individuals and families, is known as the "principle of subsidiarity."[5]

THE NEW OBJECTIVE OF WELFARE FOR ALL HAS PROBABLY COME TO STAY

It is undoubtedly true that individuals should be given a large measure of responsibility for their own welfare if they are to become strong, self-reliant, and independent in thought and action. At the same time, however, the operation of chance, adversity, war, and the business cycle frequently leaves people in poverty through no fault of their own. From a social point of view, therefore, it is desirable and essential that some minimum provision should be made for the income, housing, and medical care of all individuals.

The impact of the great depression beginning in 1929 brought a profound change in the thinking of the American people on the social welfare function of government. The extent to which government will continue to expand its activities in this field will depend on the success of government in regulating the institutions of capitalism so as to provide full employment and full utilization of capacity, as well as upon a realization by our citizens that in large measure individual well-being should be achieved through individual effort.

IMPACT OF DEFENSE ON NATIONAL ECONOMIC POLICIES

Economists have long recognized that defense and national security are of such importance to a country that they claim priority over the aim of economic welfare. Adam Smith, for example, declared that "defense . . . is of much more importance than opulence." When defense assumes the con-

[5] See also Bernard W. Dempsey, *The Functional Economy* (Englewood Cliffs, N.J., 1958), pp. 266–284.

tinuing significance which it does today, it is inevitable that the defense programs will have a major impact on national economic policies. This means that national policies will reflect in varying degrees not the fulfillment of the economic functions of government, but rather the political function of national security.

Economic mobilization in time of war requires the making of drastic changes in the economy. Planning by private enterprise must be replaced by government control. Centralized control is necessary (1) to insure the maximum supplies of man power, materials, and equipment necessary for defeating the enemy; and (2) to curtail, in various degrees, civilian production to vitally essential needs. Man power must be mobilized for the armed forces, and labor must be directed into war production and essential civilian activities. Materials, transportation, and capital investment must be utilized in accordance with a system of priorities, and scarce consumer goods must be rationed. Since government needs money and materials in a hurry, resort generally is made to large-scale borrowing. Inflationary pressures are created, and a system of price and wage controls must be established to retard and minimize inflation.

The economics of war is a specialized study beyond the scope of the present book. National security, however, is a continuing problem, and today it stands as a key factor influencing and shaping many of our national economic policies. The full impact which national security is having on our economy can only be surveyed and determined with time. Certain generalizations, however, appear to be warranted. We may note these briefly in order to provide a setting for our main study of business regulation. In summary form, they are as follows:

1. The probable continuation of high-level defense expenditures for a decade or more. Attendant problems are high federal taxes or large budgetary deficits and an enormous public debt. Heavy tax burdens or large deficits, in turn, bear in various degrees upon economic incentives, the adequacy of private investment funds, the maintenance and expansion of social welfare programs, and the availability of funds for the efficient conduct of traditional governmental functions—such as business regulation and control.

2. A tendency toward greater economic concentration. The Army, Navy, and other defense procurement agencies follow a policy of placing major defense contracts with the dominant companies. Such a practice, they believe, saves time and centralizes responsibility for deliveries. Research grants, moreover, are usually made to the large companies which maintain extensive laboratories.

3. A continuing bias in the economy towards inflation occasioned (1) by high-level defense expenditures and (2) by fiscal and monetary policies adopted to maintain maximum output and employment.

4. The probability that the antitrust laws will not be actively enforced in industries closely related to defense activity. The prosecution of antitrust cases takes the time of corporate executives for conferences with attorneys

and for court appearances. Since the "interest of defense" requires adequate supplies of essential materials, it is quite unlikely that the antitrust agencies will be permitted to file cases against companies heavily engaged in defense activity. Such prosecutions, it is reasoned, might limit or handicap productive activity. Antitrust cases which involve requests for the dissolution of monopolistic enterprises also will not be brought or will be settled without substantial remedial change, on the ground that now is no time to tinker with industrial organization.

5. A continuing program of providing economic and technical assistance to allied nations and underdeveloped areas.

6. The broadening use of programs designed to restrict imports of raw materials—such as petroleum products—and manufactured goods which involve important technology, to insure a vigorous domestic industry for national security. Such programs mean higher prices, smaller supplies for domestic consumers, and a more rapid exhaustion of our nonrenewable resources. However, as Adam Smith has said, "defense . . . is of much more importance than opulence."

An example of the practice of government to restrict imports in the interest of national security is found in the mandatory controls on all petroleum products which President Eisenhower imposed on March 10, 1959. In his words, "The new program is designed to insure a stable, healthy industry in the United States capable of exploring for and developing new hemisphere reserves to replace those being depleted. The basis of the new program . . . is the certified requirements of our national security which make it necessary that we preserve to the greatest extent possible a vigorous, healthy petroleum industry in the United States."[6]

7. The planning of expansion goals for the economy in order to insure the existence of a strong economic base for the "cold war" and for defense. The belief of some American leaders is that we are now losing the cold war. By the "cold war" is meant all the means, other than military applications, by which the Soviet Union hopes to make over the world in its image.

Senator Henry M. Jackson, a recognized authority on the problems of defense, believes that a coherent and purposeful national program must be adopted and followed to fortify our position in the cold war. Toward this end he proposes that our national policy should provide for an increase in our gross national product of at least 5 percent per year.

THE TASK OF CREATING A SYSTEM OF ECONOMIC INSTITUTIONS

The economic function of government, we have said, is to establish a system of institutions to (1) promote economic growth and stability and (2)

[6] Details on the oil import program can be secured from the Oil Import Administration, United States Department of the Interior, Washington 25, D.C.

provide for equitable prices and incomes in harmony with the public welfare.

In brief, it may be said that an institution is the *form of order* or *social arrangement* which people adopt to meet a concrete problem or to effect a common interest.

Economic activity in the United States, in the Soviet Union, and in other countries as well, is carried on by means of a *set of institutions* which determine the way in which goods and services are *produced* and *shared* by members of the society. The "economic system" of a nation consists of the totality of institutions by which economic activity is conducted.

In large measure, the economic institutions which exist at any given time—whether in capitalism or in a socialist society—are those which have been recognized, developed, adopted, or created by government. The economic task of government is to give constant attention to the direction, implementation, limitation, and improvement of these institutions.

A distinguishing feature of our American political system—and of Western political tradition—is the doctrine that institutions are made and exist for men, and not that men exist for institutions. Man is the end and not the means. In so far as property rights, corporate organization, and established forms of public control promote human welfare, they find general support and maintenance. However, if experience proves that existing institutions impede welfare, they can and should be modified. Our political system—as distinguished from that of communism—does not subordinate individuals to the inexorable maintenance of a fixed set of institutions. Our traditions uphold a free way of life and individual welfare; and provision is made in the democratic process for the establishment, adjustment, and change of institutions to accomplish these ends.

The origin of institutions is to be found in the thought, inspiration, ideals, and experience of people in a community with respect to the circumstances which confront them. An economic problem exists—for example, a business depression or a monopolistic industry—and this circumstance gives rise to discussion of a solution. In the solution of economic problems there are frequently alternatives, and the institution established is often a compromise or an adjustment between contending possibilities. It is also one which is broadly in line with the social philosophy currently held by politically important groups of people. Ideas may live in people's minds for decades, even centuries, before they become established in the form of an institution.

A law, itself, is not an institution; it is rather a means for establishing, defining, modifying, or regulating an institution. Thus, the antitrust laws seek to preserve and maintain the institutions of *free enterprise* and *price competition*. Some examples of institutions which have been created by government include standard money, a centralized reserve banking system, the business corporation, tariffs, public utilities, and social security. Although many economic institutions have become established without formal action by government—institutions such as private property, private business enterprise, marine insurance, partnerships, and collective bargaining—they are

usually brought within the legal system for purposes of regulation and control. Strictly speaking, a business practice becomes an institution only when there is government recognition and acceptance of it.

Since institutions are developed to meet certain conditions in point of time, there is often a lag between the established institutions and the current needs of the community. The institution of protective tariffs to promote infant industries, for example, may have been a solution to a need of the United States a century ago, but it has little, if any, social utility today.

Economic institutions are always in process of alteration and change. To a considerable degree, they flow from and reflect the interests of influential economic groups. Within a wide range of choice, economic institutions can be chosen or modified by the people as a whole. Our corporation statutes, our antitrust laws, and our agencies of regulation and control are all man-made. Public policy, in large measure, waits upon an expression of the kind of society which we desire.

SUMMARY

Government is the *agency* or instrument of the state. The state, in turn, is an association of people living in a defined territory. Government has three main functions: (1) to protect the liberty of its citizens, (2) to promote the social welfare, and (3) to create and operate a system of economic institutions. Economic institutions are social arrangements by means of which business and economic life generally are organized, directed, conducted, and regulated. In exercising its economic function, government usually endeavors (1) to promote the maximum production of goods and services and (2) to provide methods for the determination of prices and incomes, so that the incomes which accrue to individuals will be in harmony with the public interest.

Following a survey of government as it operates in the American economy (Chapter 2), we shall consider the particular ways in which business and economic life are shaped and directed by government.

2

The American System of Government and Business Regulation

The purpose of the present chapter is to proceed with a discussion of the American system of government as a mechanism for making and administering business regulations. What is the legal basis for the public regulation of business in the United States? How is political power divided between the federal and state governments? How much authority does the federal government have to regulate business?

THE CONSTITUTION AND THE SEPARATION OF POWERS OF CONTROL

In establishing the American government the founders provided for the federal system, with political power to be divided between the national government and the individual states. This form of government appears to have been created as a compromise between the representatives of the states then existing and the general desire of the people for a better government than the one then existing. There was general agreement that the object of a free people was to preserve their liberty and private rights, and that such preservation should be done by the imposition of constitutional restraints on the activity of government. The Constitution, accordingly, was drawn to provide for (1) the delegation of certain powers to the federal government, (2) the reservation, in general, of other powers to the states, and (3) the imposition of restrictions on the exercise of power by both governments.

The functions delegated or assigned to the federal government include certain enumerated powers which bear directly on the operation of the economic system. These are as follows:

1. The regulation of commerce "with foreign nations, and among the several states, and with the Indian tribes."
2. The establishment of a uniform rule on bankruptcies.

3. The coinage of money, the regulation of the value of money, and the punishment of counterfeiting.
4. The fixing of standards of weights and measures.
5. The establishment of post offices and post roads.
6. The issuance of patents and copyrights on discoveries and writings.
7. The levying of taxes, duties, and excises, and the borrowing of money.

Other important powers of the national government are (1) the power to declare war and provide for the national defense, (2) the power to "make all laws which shall be necessary and proper" to carry into execution the powers vested in the national government, and (3) certain "inherent" powers which belong to a national government—such as the power to grant citizenship and the power to acquire territory.

The Constitution provides for a distribution of power among the legislative, executive, and judicial branches of government. This provision was made to prevent an undue concentration of power within the national government, and thus further to protect personal liberties and private property.

A further restriction on the exercise of political power was subsequently developed in the practice of judicial review. Soon after the federal courts began to function, they faced the question of whether or not certain acts of Congress were in harmony with the Constitution. In 1803 in the famous case of *Marbury* v. *Madison* the Supreme Court held that a clause of the Judiciary Act of 1789 was contrary to the Constitution.[1] By this action the Court established a precedent for the enforcement of only those statutes passed by Congress which in its opinion are in accordance with the Constitution.

The powers not delegated to the national government or prohibited to the states were reserved to the states or to the people. The broad, residuary power reserved to the individual states by the Constitution is frequently called the "police power" of the states. Such power includes the general authority to enact legislation to promote the health, morals, education, and general welfare of the people.

SPECIAL PROTECTION TO PROPERTY GIVEN BY THE CONSTITUTION

At the time the Constitution was adopted many people were concerned that the government might sometime interfere with their liberty or property, and this fear led to the adoption of the constitutional provision that "no person shall be deprived of life, liberty or property without due process of law."[2] According to Professor E. S. Corwin, "originally, 'due process of law'

[1] *Marbury* v. *Madison,* 1 Cranch 137 (1803).

[2] The Fifth Amendment imposes this restriction on the national government, and the Fourteenth Amendment imposes it on the states.

meant simply the modes of *procedure* which were *due* at the common law." At the present time, however, he continues, "'due process of law' means 'reasonable' law or 'reasonable' procedure, that is to say, what a majority of the Supreme Court find to be reasonable in some or other sense of that extremely elastic term."[3] Thus, in reviewing a limitation of property rights—or a restriction on freedom of contract—the Court considers whether Congress or a state legislature has exercised its powers reasonably.

The powers employed by the federal government over property include the power to regulate interstate commerce, the war powers, and the power to control business "affected with a public interest." These powers of the federal government resemble the police powers of the state governments, and they are sometimes referred to as the federal "police powers."[4] State governments likewise frequently interfere with property rights in exercising regulatory power at the state level. Both the federal and state governments modify or change property rights under the power of "eminent domain," which is a sovereign right of government, as such. In the exercise of this right, a government or its agency can take private property for a public use, even though the owner is unwilling, provided that just compensation for the property is paid.[5]

The doctrine of "eminent domain," it may be noted, does not mean that governments make compensation for all their acts which adversely affect the value of property. Thus, in times of revolution, when a new government takes private property, compensation is rarely, if ever, provided. Further, the action of the federal government in lowering tariffs, in destroying private monopoly power, and in declaring war does not provide grounds for compensation for those who suffer loss. The taking of such action, it is held by the courts, is a normal consequence of the exercise of lawful power.[6] Likewise, the people, themselves, by constitutional amendment can destroy private property rights in various objects without providing compensation. This was done by the Thirteenth and Eighteenth Amendments, which respectively abolished slavery and prohibited the manufacture and sale of intoxicating liquors.

[3] E. S. Corwin, *The Constitution and What It Means Today* (Princeton, 1947), p. 170.

[4] See *Passenger Cases*, 7 Howard 283, 423-424, 425 (1849).

[5] The Fifth Amendment to the Constitution specifically provides, "nor shall private property be taken for public use without just compensation." Nearly all state constitutions have a similar provision limiting the power of the particular state government.

[6] *Knox* v. *Lee*, 12 Wall. 457 (1871); and *Omnia Commercial Co.* v. *U.S.*, 261 U.S. 502 (1923). In *Knox* v. *Lee* the Court held that the Fifth Amendment, which forbids the taking of private property for public use without just compensation, applies only to "a direct appropriation, and not to consequential injuries resulting from the exercise of lawful power." The Court recognized that "a new tariff, an embargo, a draft, or a war, may inevitably bring upon individuals great losses; may, indeed, render valuable property almost valueless," but held that government does not have to provide compensation for such losses.

THE FUNCTION OF BUSINESS REGULATION IS BASED LARGELY ON THE "POWER TO REGULATE COMMERCE"

The Constitution of 1789 gave Congress the power to regulate commerce among the several states; and in the famous case of *Gibbons* v. *Ogden* (1824) the Supreme Court held that the power to regulate such commerce was

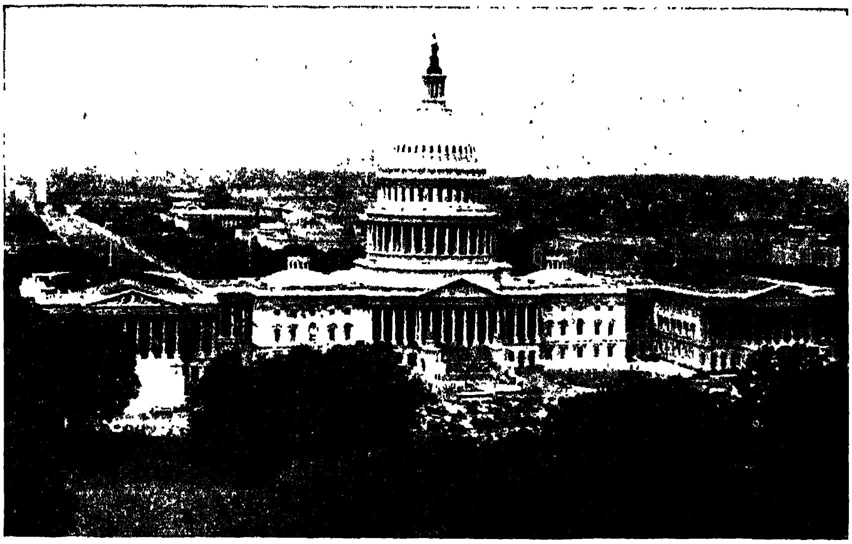


FIGURE 3. Regulation of business by Congress is based largely on the "power to regulate commerce." *Commerce* means the buying and selling of commodities. The Court has construed the concept of commerce broadly to include all aspects of commercial intercourse, including labor services, agriculture, mining, manufacturing, communications, and transportation, which are *interstate* or which bear substantially on interstate activity. Other important powers of Congress relating to the conduct of business are the "taxing power" and the "war power."

vested solely in the federal government.[7] To the claim that the term "commerce" is limited to *traffic*—that is, the buying and selling of commodities—Chief Justice Marshall replied: "Commerce, undoubtedly, is traffic, but it is something more—it is intercourse. It describes the commercial intercourse between nations, and parts of nations, in all its branches, *and is regulated by prescribing rules for carrying on that intercourse*" (italics added). Justice

[7] *Gibbons* v. *Ogden*, 9 Wheaton 1 (1824). According to Chief Justice Marshall, the phrase "among the states" means "that commerce which concerns more states than one" and is not "the exclusively internal commerce of a state."

Johnson, in his concurring opinion, added: "Commerce, in its simplest signification, means an exchange of goods; but in the advancement of society, labor, transportation, intelligence, care, and various mediums of exchange become commodities, and enter into commerce; the subject, the vehicle, the agent, and their various operations, become the objects of commercial regulation."

CONGRESS HAS POWER TO PROVIDE FOR ANY KIND OF ECONOMIC SYSTEM

No specific guides are provided in the Constitution for the use of Congress in exercising its power to regulate commerce. Rather, the function of Congress in regulating business is to make such rules as it finds are necessary and desirable. In *Gibbons* v. *Ogden*, Chief Justice Marshall declared that the power of Congress to regulate interstate business activity is "complete" and "absolute." The discretion of Congress in selecting the ends or purposes of regulation, he stated, is subject neither to constitutional limitation nor to judicial review. The "sole restraints" on which the people must rely to protect themselves from abuse are "the wisdom and discretion of Congress, their identity with the people, and the influence which their constituents possess at elections."

The term "regulate," as Chief Justice Marshall stated, has the basic meaning of prescribing rules for the conduct of business activity. Subsequently, the power of Congress over commerce was interpreted by the Court to include the actual setting of rates on transportation from one state to another. With the advent of the New Deal in 1933, the Court interpreted the power "to regulate commerce" to include the power to fix prices, wages, and outputs in various sectors of general business activity.

In summarizing the power of Congress over commerce, Professor E. S. Corwin says: "The power 'to regulate' is the power to govern, that is, the power to restrain, to prohibit, to protect, to encourage, to promote, in the furtherance of any public purpose whatsoever, provided the constitutional rights of persons be not transgressed."[8]

FEDERAL REGULATION THROUGH TAXATION

Federal regulation of business is also exercised under the power to levy taxes. Ever since the first revenue act of 1789, Congress has from time to time enacted tax legislation for social and economic purposes rather than for the primary purpose of raising revenue. A protective tariff, for example, is a tax levied for the purpose of excluding foreign competition. Some revenue is usually secured, but revenue is not the main purpose of the tax. In upholding the constitutionality of a protective tariff, the Supreme Court declared:

[8] E. S. Corwin, *The Constitution and What It Means Today* (Princeton, 1958), p. 33

"So long as the motive of Congress and the effect of its legislative action are to secure revenue for the benefit of the general government, the existence of other motives in the selection of the subjects of taxes cannot invalidate Congressional action."[9]

In upholding a heavy tax on the buying and selling of sawed-off shotguns, the Court declared: "Every tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed. But a tax is not any the less a tax because it has a regulatory effect. . . . Inquiry into the hidden motives which may move Congress to exercise a power constitutionally conferred upon it is beyond the competency of the courts."[10] In certain situations, it is possible that a tax may be so heavy as to suppress a business activity altogether.

The Supreme Court has also held that Congress may use the power to tax as a penalty or sanction in the regulation of commerce. In the Bituminous Coal Act of 1937, for example, Congress placed a tax of 19½ percent on the market price of coal produced and sold by firms not participating in the price-fixing program. The Supreme Court upheld this use of the taxing power "in aid of the regulation of interstate commerce." According to the Court, "Clearly this tax is not designed merely for revenue purposes. In purpose and effect it is primarily a sanction to enforce the regulatory provisions of the Act. But that does not mean that the statute is invalid and the tax unenforceable. Congress may impose penalties in aid of the exercise of any of its enumerated powers. The power of taxation, granted to Congress by the Constitution, may be utilized as a sanction for the exercise of another power which is granted to it."[11]

THE AMERICAN DOCTRINE OF LAISSEZ FAIRE

Although the Supreme Court in *Gibbons* v. *Ogden* (1824) declared that the power of Congress to regulate interstate business is complete and absolute, Congress actually did very little in the way of exercising its regulatory power prior to the advent of the New Deal in 1933. The inaction of Congress—as well as the state governments—in the field of regulation is largely to be explained by the view which early developed in politically important circles that government should exercise a minimum of interference in the conduct of economic affairs. President Van Buren, in his message to Congress on September 4, 1837, for example, declared:

> All communities are apt to look to government for too much. Even in our own country . . . we are prone to do so, especially at periods of sudden embarrassment and distress. But this ought not to be. The framers of our excellent Constitution and the people who approved it with calm and sagacious deliberation acted at the time on a sounder principle. They wisely

[9] *J. W. Hampton, Jr.* v. *U.S.*, 276 U.S. 394, 412 (1928).

[10] *Sonzinsky* v. *U.S.*, 300 U.S. 506, 513-514 (1937).

[11] *Sunshine Anthracite Coal Co.* v. *Adkins*, 310 U.S., 381, 393 (1940).

judged that the less government interferes with private pursuits the better for the general prosperity. It is not its legitimate object to make men rich or to repair by direct grants of money or legislation in favor of particular pursuits losses not incurred in the public service. This would be substantially to use the property of some for the benefit of others.[12]

The full flowering of the American doctrine of laissez faire came with its acceptance by the Supreme Court and with the use of judicial review to set aside legislation which a majority of the Court believed meddled unnecessarily with the freedom of contract. Professor E. S. Corwin suggests that the judicial acceptance of a doctrine of laissez faire had its origin largely in the organized efforts of the American Bar Association, which was founded in 1878.[13] The spokesmen and leaders of this organization were, and continue to be, lawyers for large business corporations, and the idea that government should pursue a "hands off" policy toward business reflected the desires of their clients. The point of view of influential business interests was well expressed by Mr. C. S. Mellen, a former president of the New York, New Haven, and Hartford Railroad Co., in testimony before a Senate committee in 1914. Said Mr. Mellen: "We did not seek so much positive legislation. . . . We could get along very well if we were let alone—very well. . . . It is not so much the things we want to do to the other fellow, as to prevent what the other fellow wants to do to us."[14] The full significance of the philosophy developed by the American Bar Association arises in the fact that from its members came a President, numerous Attorneys General, and ten future justices of the Supreme Court.

In the minds and legal briefs of corporation lawyers, the doctrine of laissez faire was a very much different policy from that advocated by Adam Smith. As urged by Smith in 1776, the idea of laissez faire was that government interference *which encourages monopoly* should be stopped. His attack centered on tariffs, exclusive trading companies, guild exclusions, and other measures confining trade and commerce to a favored few. Government intervention which promotes the general welfare was good. In a study of the exceptions which Adam Smith made to the principle of laissez faire, Professor Jacob Viner found no less than twenty-six instances in which Smith advocated government intervention to protect the public interest.[15]

In the United States, tariff favors and subsidies soon came to be widely granted by the federal government to industry groups under the influence of powerful business lobbies. It was this sort of intervention that Adam Smith so vigorously condemned. In the twisted version of "let alone" developed by the American bar, laissez faire was declared to mean that business interests

[12] *Messages and Papers of the Presidents* (New York, 1897), Vol. 4, p. 1561.

[13] E. S. Corwin, *Liberty Against Government* (Baton Rouge, 1948), p. 138.

[14] Senate Document 543, 63rd Congress, second session, 1914, p. 924, quoted by V. O. Key, Jr., *Politics, Parties, and Pressure Groups* (New York 1952), p. 176.

[15] Jacob Viner, "Adam Smith and Laissez-Faire," in *Adam Smith, 1776–1926* (Chicago, 1928), pp. 134–155.

should be privileged to conduct their transactions as they please, without public regulation. The long tradition of the common law that economic competition should be regulated and supervised and that markets should be created and maintained for buying and selling was either forgotten or ignored.

Increasingly, the Supreme Court came to accept the doctrine of laissez faire urged by corporation lawyers in their legal briefs. This doctrine was that competition is an unregulated process, conducted without public rules or penalties, which should not be restricted as long as it is carried on in good faith to make profit. Under the banner of laissez faire and economic freedom, business was allowed to develop largely as it pleased. "Free competition" meant a freedom to conduct business affairs without government regulation or restriction. Local price cutting, rebating, and the use of "fighting" ships and brands were all looked upon as being legitimate acts of competition. Many business leaders declared that "competition is a state of war," to be waged without adhering to rules of fair play or without regard to moral principles of right and wrong. Such was the essential nature of laissez-faire ca

THE USE OF JUDICIAL REVIEW TO LIMIT BUSINESS REGULATION

From about 1895 with few exceptions through 1935, the Supreme Court gave repeated expression to its doctrine of laissez faire and to its acceptance of competition as an unregulated, unrestricted process. By means of interpretation and judicial review, it succeeded in limiting, restricting, or nullifying a large part of the constructive legislation passed by Congress, as well as by the states, to provide rules and penalties, public administration and supervision, to keep economic competition within the bounds of public welfare. The Sherman Act of 1890, which was passed by Congress to provide for the preservation and maintenance of fair competition, was repeatedly weakened by decisions holding (1) that it did not apply to manufacturing activity and (2) that it condemned monopoly only when there were actual abuses. Further efforts of Congress to prevent monopoly and maintain competition by enacting the Federal Trade Commission and the Clayton Acts were, as we shall see, likewise limited or nullified.

In the field of social legislation, the Court similarly gave expression to its special brand of laissez faire. A state law in New York limiting the work in bakeries to ten hours per day and sixty hours per week was set aside as being an unwarranted interference with the right of free contract. Although the state presented evidence to show that bakers frequently suffer from inflammation of the lungs and bronchial tubes, running eyes, and sore legs, resulting from their long hours of work under conditions of heat and flour dust, the majority of the Court held that limitations on the hours of labor "are

mere meddlesome interferences with the rights of the individual."[16] In a strong dissenting opinion, Justice Holmes declared: "This case is decided upon an economic theory which a large part of the country does not entertain. . . . A Constitution is not intended to embody a particular economic theory, whether of paternalism . . . or of *laissez-faire*. . . . I think that the word 'liberty,' in the 14th Amendment, is perverted when it is held to prevent the natural outcome of a dominant opinion."

Again, in 1923, the Supreme Court held that a minimum wage law for women passed by Congress for the District of Columbia was an unwarranted interference with the due process clause of the Constitution. According to Justice Sutherland, speaking for a majority of the Court, "But freedom of contract is, nevertheless, the general rule and restraint the exception; and the exercise of legislative authority to abridge it can be justified only by the existence of exceptional circumstances."[17]

Professor Alpheus T. Mason has called particular attention to the *political* role of the Supreme Court. "The myth persists," he declares, "that the justices are but mouthpieces of the law and may themselves will nothing. It has been asserted that when the Supreme Court is confronted with a claimed violation of the Constitution it must lay the constitutional provision that is invoked beside the act [law] that is challenged and decide whether the latter squares with the former. In making that decision, the Court cannot be at all influenced by what it deems the desirability or undesirability of the legislation in question." Professor Mason calls this statement a "wholly unrealistic description of the judicial process." In his view, "No good purpose can be served by trying to perpetuate the fiction that judges operate in a nonpolitical vacuum, above any personal considerations, and beyond political influences."[18]

PRESENT CONCENTRATION OF POWER IN THE FEDERAL GOVERNMENT

Today, in sharp contrast with the conditions which prevailed before the great depression, the federal government has come to exercise a vast amount of direction and control over the economic life of the nation. In place of the long-held judicial theory that government intervention in the economic field should be held to a minimum, the Supreme Court beginning in 1937 adopted a positive view that Congress is entitled to exercise fully its powers to meet the needs of popular government and the growing complexities of present-day economic life. The doctrine of dual sovereignty, whereby the

[16] *Lockner* v. *New York*, 198 U.S. 45, 61 (1905).
[17] *Adkins* v. *Children's Hospital*, 261 U.S. 525, 546 (1923).
[18] Alpheus T. Mason, *The Supreme Court from Taft to Warren* (Baton Rouge, 1958), p. viii.

states and the national government were regarded as "sovereign" in their respective jurisdictions, has, moreover, largely ceased to be a check on the regulatory action of the national government. "Not again for a long time," says Professor E. S. Corwin, "will the Court hold void an act of Congress against which nothing can be said by way of constitutional objection except that it invades the accustomed field of state power and tends to upset the Federal equilibrium."[19] Likewise, the principle of judicial review has been greatly weakened as a restraint on Congressional power, with the growing willingness of the Court to accept the legislation of Congress designed to meet emergent needs in the social and economic fields.

REASONS FOR THE CHANGED ATTITUDE OF THE SUPREME COURT

Why, it may be asked, has the Court changed so completely in its interpretation of the Constitution? Why has it permitted "big government," so called, to develop? Some of the widely publicized economic facts which confronted the Court, as well as the general public, in 1937 included (1) growing economic concentration, with 200 of the larger corporations controlling some 50 percent of all corporate wealth and exercising an even greater domination by means of interlocking directorates, formal agreements, secret understandings, and other devices for securing unity of action; (2) great disparities in personal incomes, with 60 percent of American families receiving insufficient incomes to supply the basic necessities, and with 1 percent of the families receiving approximately as much total income as the 42 percent of the families at the bottom of the scale; and (3) widespread economic insecurity and depression, with the estimated number of unemployed reaching a total of 10,983,000 persons in 1937. When faced with these facts and many other related ones, the Supreme Court suddenly discarded its laissez-faire theory of government and adopted instead the view that government is free to adopt whatever economic policies it believes are necessary to promote the public welfare. Of this change it has been said, "A switch in time saved nine!"

EXPANSION IN THE SCOPE OF THE COMMERCE POWER AFTER 1937

The term "interstate commerce" is not defined in the Constitution, and its meaning must be found in the decisions of the Supreme Court interpreting the scope of the power of Congress. In early decisions on the commerce clause, the Court held that interstate commerce covered only the buying and

[19] E. S. Corwin, *Constitutional Revolution, Ltd.* (Claremont, Calif., 1941), p. 108.

selling of goods to be shipped across state lines and the transportation of such goods. The regulation of manufacturing, mining, and agriculture was held to be beyond the scope of the power granted to Congress. Thus, in the Sugar Trust case decided in 1895, the Court accepted the view, urged by a combination producing 98 percent of the sugar used in the United States, that "production" is separate and distinct from "commerce."[20] Upon the basis of this view, the Court held that Congress could not regulate manufacturing, agriculture, mining, the production of oil and natural gas, quarrying, or the production of electric energy. As late as 1936, the attempt of Congress to regulate manufacturing or processing activity was set aside on the ground that production is not a part of commerce among the states.[21]

A sharp reversal in the opinion of the Court on the scope of interstate commerce came in 1937 in a case involving the constitutionality of the National Labor Relations Act. This act, passed by Congress in 1935, gave workers engaged in interstate commerce the right to organize and bargain collectively through representatives of their own choosing. The Jones and Laughlin Steel Corporation, a large producer of steel with mills and other productive facilities located in many states, was accused of discharging several employees for union activity. In its reply the company took the position that the federal government had no jurisdiction because the men were engaged in *manufacturing*, which is not interstate commerce. The Court, however, upheld the application of the act upon a consideration of "the plainest facts of our national life." Since the effect of labor strife would be "immediate" and possibly "catastrophic" on interstate commerce, the Court held that Congress had "competent legislative authority" to enter the labor relations field and grant workers in the steel industry the right to organize and bargain collectively.[22]

In the case of *U.S.* v. *Darby* (1941), the Court held that Congress in the Fair Labor Standards Act of 1938 could reach directly into the sphere of manufacturing activity. By the terms of the act, Congress imposed prohibitions on (1) the shipment in interstate commerce of goods produced by labor whose wages are less than a prescribed minimum or whose compensation for overtime is at a rate less than time and one-half for hours in excess of forty a week, and (2) the employment of workmen in industrial production for interstate commerce at other than the prescribed wages and overtime rates of pay. Sustaining the act, the Court held that the power of Congress "extends to those activities intrastate which so affect interstate commerce . . .

[20] *U.S.* v. *E. C. Knight Co.*, 156 U.S. 1 (1895). In economics commerce means *exchange*—that is, buying and selling or the making of ownership changes. Since manufacturing, mining, agriculture, and other forms of productive activity are almost always carried on for sale, it follows that they practically always involve "commerce."

[21] *Schechter Bros.* v. *U.S.*, 295 U.S. 495 (1935); *Carter* v. *Carter Coal Co.*, 298 U.S 238 (1936).

[22] *National Labor Relations Board* v. *Jones and Laughlin Steel Corp.*, 301 U.S. 1, 41 (1937).

as to make regulation of them appropriate means to the attainment of a legitimate end."[23]

In the Darby case, the Court conclusively broke with its past decisions holding that the commerce clause *did not* give the federal government power to regulate production, including agriculture, mining, manufacturing, and the employer-employee relationship. All this was changed by the impact of the great depression and the coming of the New Deal. Today Congress has the power to regulate manufacturing, mining, agriculture, and the employer-employee relationship whenever the products enter into interstate commerce, are a part of commerce, or "affect" such commerce. Professor E. S. Corwin has called this change in the construction of the commerce clause "the Constitutional Revolution."[24]

FURTHER PENETRATION BY CONGRESS INTO THE FIELD OF PRODUCTION

In the case of *Wickard* v. *Filburn* (1942), the Court upheld the Agricultural Adjustment Act of 1938, which limited the amount of wheat that a farmer could grow even when the production was not intended for sale, but only for use on the producer's farm. According to the Court, "Even if appellees' activity be local and though it may not be regarded as commerce, it may still, whatever its nature, be reached by Congress if it exerts a substantial economic effect on interstate commerce and this irrespective of whether such effect is what might at some earlier time have been defined as 'direct' or 'indirect.' "

The Court pointed out, in *Wickard* v. *Filburn*, that the purpose of production control in agriculture was to support the price of wheat:

> It can hardly be denied that a factor of such volume and variability as home-consumed wheat would have a substantial influence on price and market conditions. This may arise because being in marketable condition such wheat overhangs the market and, if induced by rising prices, tends to flow into the market and check price increases. But if we assume that it is never marketed, it supplies a need of the man who grew it which would otherwise be reflected by purchases in the open market. Home-grown wheat in this sense competes with wheat in commerce. The stimulation of commerce is a use of the regulatory function quite as definitely as prohibitions or restrictions thereon. This record leaves us in no doubt that Congress may properly have considered that wheat consumed on the farm where grown, if wholly outside the scheme of regulation, would have a substantial effect in defeating and obstructing its purpose to stimulate trade therein at increased prices.[25]

[23] *U.S.* v. *Darby*, 312 U.S. 100, 118 (1941).
[24] E. S. Corwin, *The Constitution and What It Means Today* (Princeton, 1958), p. 46.
[25] *Wickard* v. *Filburn*, 317 U.S. 111, 125 (1942).

In the case of *U.S.* v. *Frankfort Distilleries* (1945) the concerted action of retail liquor dealers in the state of Colorado to force producers to enter into "fair trade" price-maintenance contracts was held to be in violation of the Sherman Act. The retail dealers maintained that their business was intrastate in character and not subject to federal control. However, Justice Black, speaking for the Court, stated that the "coercive power" of the combination was "used to compel the producers of alcoholic beverages outside of Colorado to enter into price-maintenance contracts." This fact, he declared, brought the local activity within the control of the federal government.[26]

A further example of the extension of federal regulatory power is found in *Mandeville Island Farms* v. *American Crystal Sugar Company* (1948). In this case, California beet sugar refiners agreed among themselves on the buying price for sugar beets grown in California. Their defense was that the purchase of sugar beets in California was a "purely local" activity and beyond the reach of the Sherman Act. The Court held, however, that "the artificial and mechanical separation of 'production' and 'manufacturing' from 'commerce,' without regard to their economic continuity, the effects of the former two upon the latter, and the varying methods by which the several processes are organized, related and carried on in different industries or indeed within a single industry, no longer suffices to put either production or manufacturing and refining processes beyond reach of Congress' authority." The test, the Court declared, for the exercise of federal power is "a showing of actual or threatened effect upon interstate commerce" which is "substantial" and "adverse" to the paramount policies of Congress.[27]

The doctrine that local activities which are a part of the flow of interstate commerce are subject to federal regulation was again affirmed in the Lorain Journal case (1951). This case involved an antitrust action brought by the federal government against a local newspaper, distributing local and out-of-state news. The Supreme Court held that the newspaper was engaged in interstate commerce and was subject to federal regulation. Said the Court: "There can be little doubt today that the immediate dissemination of news gathered from throughout the nation or world by agencies specially organized for that purpose is a part of interstate commerce."[28]

Upon the basis of today's brand of constitutional law, it would appear that the federal government is constitutionally entitled to regulate agriculture, manufacturing, mining (including the production of oil and gas), and retail trade, whenever the conduct of such activity has a "substantial" and "adverse" effect on interstate business. In the present view of the Court, the sale, shipment, and transportation of products across state lines—the narrow concept of interstate commerce—cannot logically be separated from (1) the firsthand production of such products or (2) their final distribution in retail trade.

[26] *U.S.* v. *Frankfort Distilleries, Inc.*, 324 U.S. 293, 298 (1945).

[27] *Mandeville Island Farms* v. *American Crystal Sugar Co.*, 334 U.S. 219 (1948).

[28] *Lorain Journal Co.* v. *U.S.*, 342 U.S. 143, 151 (1951).

If the federal government so desired, it would appear that it could take over most, if not all, of the antitrust activity at the state level. Likewise, the federal government would appear to be entitled to assume control of the production of oil and gas in order to conserve this highly valuable resource.

INTERNATIONAL CONFLICT AND THE FURTHER GROWTH OF FEDERAL POWER

The commerce clause, we have seen, provides the most important peacetime source of power for the federal government in regulating business. In time of war or to provide for the national defense, the "war power" becomes the all-important basis for control.

During World War II, the greatly enhanced peacetime power of the federal government was further increased by the "emergency demands" of total war. Warfare has always made for a strengthening of the national political authority; and the unprecedented demands of World War II for a unified control of all resources brought forth detailed regulations setting maximum prices and rents, fixing wages and hours of work, establishing working conditions, controlling the utilization of raw materials and man power, and absorbing excess profits by means of special taxes.

In considering the plea of an apartment house owner that the rentals fixed by the Office of Price Administration did not provide a "fair return" on her investment, the Court declared: "A nation which can demand the lives of its men and women in the waging of that war is under no constitutional necessity of providing a system of price control on the domestic front which will assure each landlord a 'fair return' on his property."[29] The case of *Yakus* v. *U.S.* went even further in limiting the rights of individuals in wartime by holding that in violating the orders of a war agency an individual may even be denied the right to plead the unconstitutionality of an act of Congress.[30] In these and other wartime cases, the Court approved the exercise by Congress of vast powers over business without subjecting the laws to any restraint.

The "war power" serves as a basis for economic intervention not only to meet the needs of a shooting war, but also to provide for the national defense. The Tennessee Valley Authority, a vast governmental enterprise for resource conservation, chemical engineering development, flood control, navigation, electric power generation, and recreation, was sustained by the Court, in part, on grounds of national defense.[31]

The Atomic Energy Act of 1946 was also enacted during peacetime to provide for the national defense. This legislation establishes a commission of five members with the power to engage in research and development activi-

[29] *Bowles* v. *Willingham*, 321 U.S. 503, 519 (1944).

[30] *Yakus* v. *U.S.*, 321 U.S. 414 (1944).

[31] *Ashwander* v. *T.V.A.*, 297 U.S. 288, 327–328 (1936).

ties on nuclear processes; the production of atomic energy; and the utilization of fissionable materials for medical, agricultural, and industrial purposes. The work of the Commission may be conducted in its own facilities or by contracts with private individuals or corporations. The Atomic Energy Commission is also empowered to produce atomic bombs and related military weapons under the direction of the President.

THE NEW CONCEPTION OF GOVERNMENT

Upon the basis of experiences in the great depression, organized labor, farm, and consumer groups have increasingly turned to government for assistance in improving their incomes and economic security. The satisfaction of these demands has made for a new and revolutionary conception of government. In the historical development of the United States, governmental policy was primarily an admixture of measures which provided (1) equality of opportunity for the common man (such as the public school system and the Homestead Act of 1862) and (2) generous favors for those who knew how to help themselves (tariff privileges, favorable corporation legislation, and ownership of the richest natural resources of the nation). With the advent of the "New Deal" in 1933—subsequently called the "Fair Deal"—however, the purpose of government was shaped and directed to that of guaranteeing economic security and "fair shares" of income for all.

An important example of the new role of government is found in the Social Security Act of 1935. This Act provides that the federal taxing-spending power shall be used to support a program of financial assistance to elderly persons, to the blind, and to dependent children; unemployment insurance; old age and survivors' insurance; maternal welfare work; vocational rehabilitation; and public health work. In upholding the Social Security Act, the Supreme Court drew upon the experiences and tragedies of the great depression, the national scope of the problem of social security, and the fact that individual states were reluctant to impose burdens on local industries when other states did not take such action.[32]

Other laws which were adopted to provide a greater measure of economic security and well-being are the Federal Deposit Insurance Act (1933), the Securities Act (1933), the Securities Exchange Act (1934), the Public Utility Holding Company Act (1935), the Wagner Act (1935), the Fair Labor Standards Act (1938), the Employment Act of 1946, agricultural price-support and subsidy legislation, and public-housing legislation.

In the main, the means employed by Congress in fulfilling its duty of guaranteeing security and welfare for all have consisted of (1) placing certain restrictions, curbs, limits, and controls upon the economically strong and wealthy groups and (2) providing financial assistance and social serv-

[32] *Carmichael* v. *Southern Coal and Coke Co.*, 301 U.S. 495 (1937); *Steward Machine Co.* v. *Davis*, 301 U.S. 548 (1937); and *Helvering* v. *Davis*, 301 U.S. 619 (1937).

ices for the general public to promote economic well-being. Since the objective of welfare for all has a broad appeal in practical politics, it is probable that the new activity of government is here to stay.

SUMMARY

As a result of the stresses and strains of the great depression and World War II, and the ensuing social need for a strong national authority, there has occurred a great concentration of power in the national government. This consolidation of power is, moreover, likely to exist for an indefinite period of time. Professor E. S. Corwin observes that as a result of the changed philosophy of the Supreme Court, "the National Government is entitled to employ any and all of its powers to forward any and all of the objectives of good government."[33] Professor Corwin, in fact, declares that the concentration of power in the national government has progressed so far that "*the control over industry recently exerted by the government through priorities and price regulation in the name of the war power could be at any moment reasserted under the 'commerce' clause for purposes of social planning.*"[34]

Since the Supreme Court apparently stands ready to support Congress in its endeavors to cope with the emergent problems of our highly complex economy, an important question from the standpoint of government and business is how the enlarged powers of the national government are to be exercised *in relation to the organization and conduct of private industry.* It is in this area that the power now concentrated in the national government has yet to be applied in any sort of effective and consistent way.

Will the strengthened power of the national government be used to create a fully competitive industrial economy? Or will the political influence of large business units cause government to adopt a policy of laissez faire? Will private enterprise continue to play a dominant role in the production of goods and services? Or will government—federal and state—assume a greater responsibility for long-term investment and development to insure economic growth? Will the people tolerate continuing inflation, particularly in the concentrated industries? Or will the federal government take responsibility for maintaining economic stability?

Will organized farm groups call upon government to prosecute the monopolistic practices of business and labor? Or will they demand a continuation of present-day price assistance programs and seek new monopolistic restrictions of their own? Will the pressure of organized producers—in industry, labor, and agriculture—for special privileges force government to control prices and output in order to restrain the more powerful groups and to strengthen the weaker ones?

[33] E. S. Corwin, *Constitutional Revolution, Ltd.* (Claremont, Calif., 1941), p. 113.

[34] E. S. Corwin, *Total War and the Constitution* (New York, 1947), p. 174. Italics added.

Will there be a continued expansion of governmental activity in the field of social welfare? Will government assume increased responsibilities for education, housing, and health? Will it be the state or federal authorities who provide the new services?

All of the foregoing questions are in process of being answered on the floors of Congress. The major struggles in our present-day politics are the struggles of economic groups for power to determine or to influence public policy bearing on the production of income and its distribution.

3

Government Regulation of Business

In a broad sense, capitalism is the form or order of business activity which our government is engaged in regulating. Capitalism may be defined as a commercial exchanging economy based upon private property in which productive activity is organized and conducted for profit. The prospect of profit is the primary motive in capitalism which causes businessmen to invest capital and produce desired goods and services.

Although capitalism is not usually considered to involve a plan, its maintenance and effective operation actually require a great deal of government intervention. The basic institutions of private property, money and credit, weights and measures, and civil law all require public intervention and implementation. Likewise, the policies of maintaining fair competition and of preventing monopoly form a plan, quite an elaborate one, which is not self-enforcing but which requires constant and unremitting attention and enforcement by government antitrust agencies—the Department of Justice, the Federal Trade Commission, and the state attorneys general. To think of the policy of competition as planless, anarchic, and free from government regulation is a fundamental error, responsible to a large degree for its present defects.

A system of capitalism is "planless" only in the sense that, with a policy of competition, businessmen are free from the dictates of a central authority in directing and planning their investment, production, and marketing programs. The government does not determine the kind and amounts of goods to be produced or directly fix or manipulate prices. Workers are, moreover, generally free to exercise individual initiative and choice in selecting an occupation and in negotiating the terms of employment. The government does, however, have the important task of providing rules and limits for competition within which business—by voluntary decisions—can and will promote the public interest while pursuing its own.

THE PROFIT-SEEKING MOTIVE

In a commercial economy most, if not all, individuals develop an active interest in money incomes and in getting the most they can for the services

they sell. A business enterpriser, in contrast with other economic groups, however, has a unique interest in money. His particular productive activity or function is one of making a money profit—a *difference* between his money expenses and his sales revenue. In the exercise of this function he invests money, buys raw materials, employs labor, borrows funds, leases rentable agents, and endeavors to sell the end products at a markup over cost. No other productive agent has profit-making as a job to do. A du Pont executive reports the story of an examination given to a group of graduating engineers who were being considered for employment. One of the questions was "What is a foundry for?" Only one engineer gave the right answer—"to make a profit."

The social welfare aspects of capitalism arise from the fact that the profit-seeking motive stimulates every possible effort to find activities showing the largest gain; and presumably the relative profits in different economic opportunities, in the absence of fraud, monopoly, and frictional elements, reflect the relative urgency of the desires of those consumers having money to make their desires effective. The profit-seeking motive, when spurred by price competition, also stimulates efforts to maximize profit by means of efficiency, high productivity, improved quality, the use of new methods, and careful, well-timed buying and selling. This is in sharp contrast with other productive arrangements wherein individuals have little or no motive to assume responsibility, to try innovations, to work long hours, to accommodate themselves to the desires of others, or to practice economy, for there is little if anything to gain by so doing, and there may be much to lose.

In a free-enterprise economy, the satisfying of human desires, the production of useful goods, and the practice of the economic virtues afford opportunities for profit. Since an enterpriser's purpose is the making of profit, it follows that it is possible for him to serve the public interest by pursuing his own. Adam Smith well expressed this view in his famous statement that a capitalist enterpriser, in given instances, is "led by an invisible hand to promote an end which was no part of his intention".[1] It is the ideal of capitalism that profits should be secured by prudent investment and efficient management.

THE NEED FOR GOVERNMENT REGULATION

Although profit-seeking may work to organize men and materials in an efficient manner to promote the social welfare, it frequently gives rise to social evils. Profit can be made not only by producing more and better goods but also by using inferior materials, by artificially restricting supply to secure monopoly profits, by misleading and deceiving consumers, and by exploiting

[1] Adam Smith, *The Wealth of Nations* (1776; 4th Cannan edition, London, 1925), Book IV, chap. 2, p. 421.

labor. The effects of these practices, and the manifold forms which they take, moreover, are cumulative. In many ways, the profit-seeking activities of dominant capitalist groups have operated to shape a nation's economic organization along lines which contribute most to their immediate commercial interests. Thus, the destruction of open markets in Western Europe and the subsequent rise of the mercantile system were manifestations of the profit-seeking drive. In more recent times, this motive on the part of some business groups has given rise to a world-wide system of tariffs, cartels, large monopoly combinations of formerly competing plants, and frequently to an influence on representative government which forestalls effective legislation in the public interest.

The advantage of money in a capitalist economy is so great that it may color an enterpriser's standards of right and wrong. In fact, there is constant danger that the opportunity to make profit may create in some enterprisers a moral blind spot, an area in their activities which is not controlled by their usual ethical standards. Persons seeking monopoly control, employing false and mendacious advertising, or exploiting labor, for example, often include men otherwise highly esteemed and respected in public life. The making of money, however, is a business practice, a stereotyped commercial tradition, and serves to influence decisions making for profit, even though they are against individual preferences.

A further aspect of a commercial economy which gives rise to a need for government intervention is the occurrence in its operation of cyclical fluctuations in business activity.[2] Throughout human history economic life has been marked by good and bad times, growing out of droughts, floods, wars, and epidemics. However, in a capitalist economy fluctuating periods of prosperity and depression have developed in the process of profit-seeking activity.

Since business enterprises are operated for profit, it follows that their productive activity and capital investment depend upon present and prospective profit. In a period of business expansion, profits tend to rise with rising prices. Increased borrowings occur, and the volume of outstanding debt rises rapidly. The ease of making profits tends to promote excesses in the use of credit and in speculative investment. Finally, the rate of earnings declines with rising costs, the security for outstanding credits is weakened, business failures and bankruptcies increase, prices fall, and widespread liquidation ensues.

Casual explanations of crises and rhythmic fluctuations of business vary in the emphasis which is placed upon different aspects of the profit-seeking process. There is general agreement, however, that the major fluctuations of the business cycle have as essential elements (1) a wide variation in the quantity of money and credit used by business and (2) a large expansion and contraction in investment activity.

[2] Wesley C. Mitchell, *Business Cycles* (New York, 1927), pp. 75 ff.; and Arthur F. Burns and Wesley C. Mitchell, *Measuring Business Cycles* (New York, 1946), pp. 3-8.

THE RISE OF COMPETITION AS PUBLIC POLICY FOR DETERMINING PRICES

During the classical period in ancient Rome—the first three centuries A.D.—governmental policy toward production, prices, and incomes, was basically that of noninterference, free initiative, and free negotiation. Selling at very high prices or buying at very low prices, reflecting one party's urgent need or another's strategic position, was not only tolerated, but publicly sanctioned. The ethics of price-making were essentially "What is, is right."

Beginning in the sixth century, however, the new idea of "just price" was introduced into Roman law. In an Imperial decree of A.D. 531 by Justinian, for example, it was held that a guardian could sell wine, oil, and grain, at will, at a just price—*justo pretio.*

How, it may be asked, did the modification of Roman law on pricing come about? It appears that the change reflected the growing belief of influential persons that there should be moral reasons which shape our lives and govern our acts. A trader, it was believed, should act not only in regard to himself, but also in regard to his neighbor. No one should take advantage of a necessitous seller or a desperate buyer. Each should have regard for his neighbor. Prices should reflect a fair medium.[3]

In order to promote justice in trading, the medieval authorities actively supported the public creation of central markets to bring together many buyers and sellers. Monopolistic practices and conspiracies on price were strictly condemned. All persons were given the liberty to enter a market and buy or sell without restraint; and trading was conducted openly and publicly. Experience had shown that in an open market the drive of a trader to buy as cheaply as he can, and to sell as dearly as he can, is effectively held in check by competing rivals. Coercion, arbitrary action, unfair treatment, discrimination, and extortion, moreover, are largely prevented. Prices are established at medium ratios which make exchange desirable to both parties. It was for this reason that competitive market prices were looked upon as being "fair" and "just," with both economic and moral advantages.[4]

THE RIGHT TO COMPETE IN ANGLO-SAXON LAW

The legal right to compete was established in England by the decisions of judges affirming that all persons have the right to follow an occupation of their own choice without dictation of others. An early case declaring this right was the Schoolmaster's case decided in 1410. In this case the Court of

[3] For further analysis, see Vernon A. Mund, "Ethical Concepts Implicit in Monopolistic and Competitive Price Analysis," *Review of Social Economy*, March, 1955, pp. 20–30.

[4] See Raymond de Roover, "The Concept of the Just Price: Theory and Economic Policy," *Journal of Economic History*, December, 1958, pp. 418–434.

Common Pleas held that two schoolmasters of a grammar school at Gloucester could not secure a writ preventing another teacher from starting a second school in the same town. The plaintiffs stated in their plea that whereas they had formerly received 40 d. a quarter from each child, the entry of the other teacher had forced them to reduce their rates to 12 d. to their great damage. The court, however, declared that when "another equally competent with the plaintiffs comes to teach the children, this is a virtuous and charitable thing, and an ease to the people, for which he cannot be punished by our law." In support of this conclusion the court quoted the opinion of Chief Justice Thirning in an earlier case to the effect that "if I have a mill and my neighbor builds another mill, whereby the profit of mine is diminished, I shall have no action against him; still I am damaged."[5]

The acceptance and actual realization of the right to compete came slowly, for strongly established monopoly groups vigorously resisted any change in their established order of control. From 1410 to 1640 in particular, the courts, as well as Parliament, repeatedly reaffirmed the principle that the liberty of free men gives them the right to engage in any trade or calling of their own choice. Gradually the right to compete became a firmly established and generally accepted principle in Anglo-Saxon Law.

The principles of competition developed in the medieval economic system became a fundamental basis for economic regulation in the United States. When the Sherman Antitrust Act was being debated in the United States Senate in 1890, Senator Hoar, a recognized authority on jurisprudence, declared: "The great thing that this bill does, except affording a remedy, is to extend the common-law principles, *which protected fair competition in trade in old times in England, to international and interstate commerce in the United States.*"[6]

THE PRINCIPLE OF FREE COMPETITION

The "right to compete"—freedom of enterprise—may be defined as the right of producers to follow an occupation of their own choice without interference or dictation by other producers or by government. In establishing this right the public authorities gave sanction and recognition to the desire and efforts of free men to make a living. They also found in the right to compete an indispensable condition for the effective operation of a private-enterprise economy. With a freedom of enterprise, society is given wide opportunity for having its various desires satisfied. Human and material resources tend to be allocated in places and at times where they are most urgently needed. Maximum production is promoted. At the same time, the selfish designs of individual producers are held in check by the freedom of

[5] *The Schoolmaster's Case*, T. B. Henry IV, f. 47, pl. 21 (1410). See also Bruce Wyman, *Control of the Market* (New York, 1914), pp. 12–14.

[6] *Congressional Record*, April 8, 1890, p. 3152. Italics supplied.

entry for newcomers and by the opportunity of consumers to turn to alternative sources of supply.

The right to compete, it may be noted, is not a guarantee that a producer will find employment or an investment opportunity. It is rather the right to bring one's labor or productive agents into competition with those of other men. The concern of government in providing the right to compete is only that the economic field be kept open—free from restraint—for anyone who may wish to enter.

ESSENTIALS OF EFFECTIVE OR COMPLETE COMPETITION

Economic competition operates in two principal ways. First, in the production of goods, competition means that enterprisers freely enter a trade or calling of their own choice when profit prospects are tempting. This is made possible by the legal right of *free competition*, free entry, or free enterprise. Secondly, in the purchase and sale of goods, competition operates as a method for determining prices and incomes. *Price competition* among sellers means that sellers *lower* their "asking" prices in relation to other sellers in order to secure customers; among buyers, it means that buyers having higher valuations *raise* their "bid" prices in order to be able to buy. Competition, in this sense, is supported by the legal freedom—and obligation—to act independently with regard to prices.

With competition, the forces of demand (units of a commodity buyers are willing to take at various prices) and the forces of supply (units offered for sale at specified prices) are brought into balance, and a uniform market price is established ("the law of supply and demand"). Market price is thus impersonally determined. It is not managed, fixed, or pegged by group action or by a price leader.

Monopolistic action (restraint of competition), which we shall discuss in the next section, means that unified action is taken to set aside or modify the free operation of market forces. Total output is curbed, and prices are raised above the competitive level. By artificially enhancing the scarcity, an organized group is able to gain higher prices and incomes (and thus secure a larger share of the national output of goods and services).

Economic well-being is measured not only by the productivity of an economy, but also by the fairness of prices and incomes. Prices and incomes determine one's share of the total output. If they are determined in ways which are not fair, just, and equitable (in the eyes of the general public), economic well-being is not achieved, regardless of the size of the national output.

The idea that competition will regulate production and prices "much better" than public or private management found its way into modern economic thought largely through the work of Adam Smith. Many present-day economists continue to affirm that competition makes for economic

abundance and for justice in prices and incomes. The "right" price or income, in their view, is one which reflects a fair medium between the extreme demands of each party. In so far as competitive conditions do not exist, it is believed, public control should be used to moderate prices and remove the element of extortion.

ALTERNATIVE METHODS FOR DETERMINING PRICES AND INCOMES

In general, there are three principal methods which government accepts or provides for the determination of prices and incomes. They consist of competition, which we have just discussed; force or monopoly; and authority. In addition to these arrangements, the distribution of income is determined in various degrees by charity and sentiment.

The Method of Force (Monopoly Power)

Distribution by force means that the stronger party gets the better of the deal by the exertion of pressure, power, or compulsion. The force used to settle prices, wages, or other conditions may be based upon physical, military, or monopoly power. On the part of sellers, monopoly power is the power to get the most that buyers will pay (or some other concession) by eliminating alternative sources of supply and by withdrawing or restricting the actual supply. The advantage of industrial monopoly is the power which it gives to make more profit by controlling and curtailing supply. A principal means which groups of workers have used for improving their position has been an organization of the labor supply and the application of economic pressure by means of strikes and restrictions on membership and output. Frequently, the economic strength of organized labor is pitted against that of organized industry, and the consequences range from joint action to raise product prices to prolonged strikes and lockouts.

On the part of buyers, monopoly power is the power to depress buying prices by excluding alternative sources of demand and by withholding purchases when sellers are eager to sell. The buyer for a dominant produce company once stated to the writer "We turned down asparagus today just to make the price soft, but we think that we shall take some tomorrow."

When prices and wages are determined by the exercise of monopoly power, there is no standard for measuring what is "just," "fair," or "equitable." Rather, the terms of settlement reflect the relative economic strength (or force) of the two parties.

Over vast areas of our present-day economy, organized groups (in industry, labor, agriculture, and the professions) have become established to exert some measure of control over supply, prices, or both. In place of individual interest and enterprise, there is "group interest," "group action," and "group

policy." The desire and objective of these groups is to set aside or modify the law of supply and demand (competition) in order to get higher prices and incomes (and thus a larger share of the national output).

Each organized group declares that it seeks only to get justice. The higher prices or incomes secured by monopolistic action, however, typically mean a transfer of income from others to the favored groups. The increased gains for some mean less income for other producers and the general public. Such action clearly violates the ethical principle that one should not gain at the expense of another.

The Method of Authority

The determination of prices and incomes by authority means that some person or persons in authority (family head, church official, or government agency) is accepted or chosen to assign or portion out the income produced by the group. Distribution by authority may be exercised in an arbitrary or discretionary manner, or it may be exercised according to rules. In time of war or other national emergency, it is usual for government to assume authoritarian control over prices, wages, and the allocation of supplies. Also in the case of public utilities, rates and earnings are usually controlled by government commissions. Special favors granted by government--such as subsidies and bounties—are a form of income distribution by authority, as is any action of government to favor one class of citizens at the cost of others.

The exercise of authoritarian *control* by governmental agencies over price is an exceedingly difficult problem, for there is no generally accepted rule on price to apply. Usually, an effort is made to find some "formula," which has the appearance of objectivity, based upon earnings in competitive industry, cost of production, or cost of living. Invariably, however, the rules of compromise and political expediency enter into the various judgments made by government agencies.

The authoritarian principle governs prices and incomes in a socialist society. In the Soviet Union, for example, the rule of work and income is "From each according to his ability, to each according to his work." In the higher states of socialist development (communism), the rule proposed is "From each according to his ability, to each according to his needs." The government, of course, is necessarily the judge of one's "work" or "needs."

STANDARDS OR YARDSTICKS FOR MEASURING "PUBLIC INTEREST" IN THE ECONOMIC SPHERE

In exercising the function of regulating business, how, it may be asked, is the "public interest" to be identified? What guiding rules or standards can government use in regulating the business relations of individuals and corporations? There is general agreement that a basic economic goal is the pro-

duction of more and better goods with less time and effort. Professor J. M. Clark states that the "most unqualified criteria of economic progress are more goods to consume and, on the side of conditions of production itself, a shorter work week and more leisure."[7] There is substantial agreement, too, that a good economic order is one in which prices and incomes are fair and just—that is, in harmony with general well-being.

From an economic standpoint, all citizens have a common interest in a living. Everyone must secure each day some part of the total national stream of real income—such as food, clothing, housing, medical and dental care, automobiles, radios, furniture, and so forth. The "consumer interest" is the interest of all citizens in getting more and better goods for consumption with less time and effort. The interest of consumers in the commerce of a nation is broader than that of any group of producers or any group of sellers. It follows, therefore, that in so far as government is concerned with promoting the "common interest" in the economic sphere, its decisions should be guided by the "consumer interest."

THE CONSUMER INTEREST IN THE STRUGGLE OF PRODUCERS' GROUPS FOR POWER AND FAVOR

What is wrong, it may be asked, about promoting the interests of producers, as such, since they are also consumers? The contrast between the interest of consumers and producers is made because an organized group of producers usually stands to gain more from a certain policy (such as legalized price fixing, a curtailment of production, an exclusion of competitors, or a protective tariff) than they stand to lose as buyers of the products of others, including their own. Producers of steel, for example, stand to gain more from a high tariff and monopolistic prices on steel than they stand to lose as consumers of the products of others which they secure in the process of exchange. Organized steel producers, therefore, even though they are consumers of steel products, demand special privileges which are against the interest of consumers generally.

In so far as government grants special privileges—such as legalized price fixing, output restrictions, and exclusions on competitors—to organized groups of producers, it makes it possible for them to force others to pay more for fewer goods. The enhancement of the prices and incomes of the organized producers means a *reduction* in the incomes of others. It is easy to see the benefit of special public favors, but the concomitant injury to others is rarely seen or considered. When once started, the process of granting special privileges to pressure groups grows rapidly as more and more organized producers, including organized labor, seek to enhance their own position or to offset the disadvantages to them occasioned by the special

[7] J. M. Clark, "Aims of Economic Life as Seen by Economists," in *Goals of Economic Life* (New York, 1953), p. 24.

privileges enjoyed by others. The effects of limiting output and restricting sales in a considerable area of productive activity thereupon become cumulative, and the end results are higher prices, unused capacity, and chronic or persistent unemployment in a large part of the whole economy.

The principle that it is an essential economic function of government in a capitalist economy to find and effectuate the consumer interest does not mean that government should never aid or favor the private interests of producers. Government, in fact, can do much to collect and disseminate reliable technical information for businessmen, laborers, farmers, and mariners. Examples of such assistance include the trade promotional activity of the Department of Commerce, the placement work of the public employment exchanges, the forecasting service of the Weather Bureau, and the soil conservation service of the Department of Agriculture. Government can also provide scientific and technical training to young men and women, and its research laboratories can be an important source of technological innovations for industry and agriculture. The point is, however, that in all these promotional activities government is also indirectly aiding the consumer interest by making it possible for individuals to produce a larger national flow of real income.

MEANING OF THE TERM "REGULATION"

In the present chapter, we have been considering the basic rules which government provides for the conduct of business activity. The title of the chapter is the "Government Regulation of Business." As a summary statement on the nature and meaning of *regulation*, we shall define and distinguish the terms "regulation" and "control."

The word "regulate" has the general meaning of (1) directing or governing by rules and (2) subjecting to guidance or restriction. In the field of government and business, the normative or usual objective of "regulation" is the provision of a *frame* within which business will and can—by voluntary decisions—do that which is socially desirable. The frame in the American economy consists, in the main, of rules, decisions, and statutes designed to (1) preserve and maintain competition and (2) prevent business from doing acts which are conceived to be socially undesirable. In providing rules for business and in deciding cases, government, in effect, declares: "If you cross this line, we shall impose penalties." Rules, decisions, and statutes serve as "warning flags" or guideposts to business firms as they otherwise pursue their own commercial interests.

A "rule" may be defined as a prescribed guide for future conduct or action. It is a specific guide—one which leaves little or no room for interpretation. The rule-making powers of administrative agencies usually provide for the making of "imperative" rules—that is, guides which must be obeyed. Imperative rules are commands.

THE FORMULATION OF RULES AND GUIDEPOSTS

Rules governing business activity usually have their origins in general statutes. Upon the basis of these statutes, various commissions have the power to formulate imperative rules (see item #4 in Table 1, pages 46–47). Persons subject to regulation are permitted to protest the rules formulated by an agency, and all rules are subject to hearing and review. Thereupon, in supervising business behavior, a commission has only to get the facts and test them against a specific rule to determine lawful or unlawful conduct. An example of a rule governing business conduct is found in the requirement of the Securities and Exchange Commission that directors of a holding company in process of reorganization shall not trade in the securities of that company during the reorganization period.

Regulatory commissions also establish guides by initiating "cases" to restrain specific kinds of activities which appear to fall within a general statutory prohibition. The Federal Trade Commission Act, for example, condemns "unfair methods of competition." It also provides for a commission to (1) get the facts on a business practice and (2) issue complaints for testing the facts in light of the general law, subject to review by the courts. This procedure is known as the "decisional process" or the "case-by-case method." In proceeding case by case, a commission does not announce beforehand stated criteria or guides for business conduct. Rather, opposing counsel vie in developing a standard which will apply the statute and dispose of the case. At the close of the hearings, the *decision* thereupon marks out lawful or unlawful conduct. In the course of time, the decisional process operates to build up principles which serve as specific guides for future business conduct.

Imperative rules provide clear-cut, specific guides for the conduct of business activity. They make the law definite and its application consistent. Businessmen can know exactly the types of activity which they should avoid. A rule-making power also makes the task of regulation more economical and expeditious, for standards of policy can be set up in advance to guide business conduct.

The case-by-case method of regulation does not provide specific guides. The interpretation of the statutes, moreover, may vary with changes in personnel and with changes in political party. Some businessmen like to operate without definite rules, but others frequently complain that the laws regulating business are vague and uncertain. The case-by-case method, however, does give a commission a freer hand in dealing with problems. In proceeding case by case, a commission is able to construe a statute strictly or leniently (with a "rule of reason"), as long as it does not act arbitrarily or capriciously. Some agencies, it may be noted, have the power to proceed case by case and also to promulgate rules.

The absence of statutory rule-making powers may reflect a desire on the

part of influential business groups to avoid specific standards for their conduct. However, it may also indicate legislative opinion that standards for regulation must be developed gradually by experience.

Government regulations are usually expressed negatively. They tell business enterprisers what they may *not* do; not what they must do. Regulatory agencies rarely prescribe positive courses of conduct—such as a rule requiring companies to quote f.o.b. mill prices, uniform to all persons at the mill.

Regulatory policies are expressed in basic statutes (such as the Sherman Act, the Clayton Act, and the Securities Exchange Act); in the decisions, prohibitions, determinations, rules, and other prescriptions of administrative agencies; and in the interpretations and decisions of the courts.

Government "regulations" are also called "indirect controls" because their purpose is to govern by providing guideposts rather than by directly determining entrepreneurial decisions. *Within the frame provided by government*, prices, output, and investment are determined by the voluntary decisions of private enterprisers and by market forces, instead of by governmental directives.

THE NATURE OF CONTROL

The word "control" is used in a general way to mean *directing* the action of others. In the study of government and business, the term "direct control" has the functional meaning of governmental action to (1) fix prices and wages (actual, minimum or maximum); (2) determine quantities produced, imported, or used; and (3) govern entry. In *controlling* business, government decides who can engage in a particular trade, how much one can produce, the price he can charge, or the minimum or maximum he can pay.

As we shall see in Chapters 20 and 21, direct, positive controls are typically used by government for three purposes: (1) to protect users and consumers from unreasonable charges made by public utilities; (2) to strengthen groups having weak bargaining power—e.g., subsidies, "price floors," and minimum wages; and (3) to restrain price inflation during periods of war and rearmament.

The terms "planning," "economic planning," and "centralized planning" are used to designate an *extreme* form of control in which government actually takes over the crucial entrepreneurial decisions. "Planning" means that prices and quantities produced are determined by or through governmental agencies rather than (1) by the decisions of private enterprisers and competition or (2) by the concerted action of private industry groups. In planning the use of economic resources, government deliberately seeks to alter the results of the market system in order to achieve certain definite ends, which in turn are different according to the prevailing ideology and the interests of influential groups. Economic planning may be partial or

total; it is partial when it is limited to one or a few sectors of the economy, and total or over-all if it is extended to all sectors.

At the present time, socialist and labor groups in a number of Western nations declare that planning should be utilized (1) to improve the incomes of workers, generally; (2) to insure full employment; and (3) to give workers a greater share in the management of industry. Such economic planning, it is usually said, should be based upon increased public ownership—especially in industries in which price competition is ineffective. Economic planning, moreover, it is believed, should be applied to both the publicly owned and privately owned sectors of the economy in order to achieve abundant production and a more just distribution of income.

MAIN PILLARS OF GOVERNMENT REGULATION AND CONTROL

The regulatory authority exercised by the various federal commissions varies greatly from one agency to another, depending upon the authority given to a particular agency by the Congress. There are certain common elements of regulation and control, however, which are exercised by the several agencies. In summary form, these main pillars are listed in Tables 1 and 2.

It may be noted that in some cases the key provisions of the basic statutes—such as the Interstate Commerce Act and the Civil Aeronautics Act—are almost identical. However, in other instances, there are important differences which are to be explained by (1) the characteristics and nature of the industries subject to federal jurisdiction, (2) the different objectives which Congress seeks to achieve through regulatory action, and (3) the influence of interest groups dominant at the time the basic statutes were adopted. The powers of a given agency, also, do not always apply uniformly to all types of companies subject to regulation. The Interstate Commerce Commission, for example, has control over entrance into business for motor, water, and rail carriers and for freight forwarders, but not for pipe lines. In the main, however, the powers shown are generally applicable to the types of business subject to the jurisdiction of the respective agencies.

The powers of *regulation*, it may be noted, relate mainly to (1) the provision of publicity, (2) the conduct of investigations and hearings, (3) the making of findings of fact and law, (4) the issuance of orders, subject to judicial review, and (5) the prosecution of violations of basic statutes or orders and rules issued thereunder. Their purpose is to provide behavior which is fair, open, aboveboard, and competitive.

The Department of Justice (Antitrust Division) unlike the other agencies, has no power to issue regulations or interpretations, to conduct hearings, to make findings, to issue orders, to direct, to prohibit, or to punish. It is a prosecuting agency, not an administrative agency. It can only institute proceedings under which *the courts* may exercise their constitutional and

Table 1. Main Pillars of Regulation

	ICC
1. Power to make findings of fact in connection with the decisional process. In proceedings for judicial review, such findings have a legal presumption of correctness if supported by substantial evidence.	Yes
2. Power to require reports by persons subject to its jurisdiction.	Yes
3. Power (and duty) to conduct investigations, require (or debar) testimony, and examine records with respect to matters within its jurisdiction.	Yes
4. Power to make rules governing business conduct subject to its jurisdiction and in accordance with basic statutes.	Yes
5. Power to restrain violations of basic statutes or orders and rules issued thereunder (cease-and-desist orders, court injunctions, revocation of licenses or certificates).	Yes
6. Power to require publication of rates and charges in a prescribed manner.	Yes
7. Power to make rules covering procedures before it.	Yes
8. Power to make studies of business practices with reference to the public interest.	Yes
9. Power to publish findings, reports, and decisions.	Yes
10. Power to recommend legislation to Congress.	Yes

Table 2. Main Pillars of Control

1. Power to prescribe and require observance of uniform accounting systems and statistical regulations, including in certain instances prescription of amounts recorded on a utility's books (i.e., the classes of property for which depreciation charges may be included in operating expenses and the percentages of depreciation to be included on such property).	Yes
2. Power to place valuations on property of a utility for use in prescribing fair and reasonable rates.	Yes[b]
3. Power to prescribe rates and charges—maximum, minimum, or actual—after full opportunity for hearings.	Yes
4. Power to control entrance into or abandonment of service.	Yes
5. Power to pass on applications to acquire or control the facilities of another company operating in the same line of business.	Yes

[a] Refers to subsidized lines only. In so far as service is set by subsidy contract, change without permission would be violation of contract.

[b] Railroads and pipelines.

[c] The authority of the CAB is limited to valuations made in the course of exercising its authority to prescribe fair and reasonable rates of compensation for the transportation of mail.

[d] Maximum and minimum rates may be prescribed for carriers from United States to territories, and between territories. Rates may be modified in all cases where they are shown to be unduly prejudicial or discriminatory.

[e] For a detailed description of this power, see 47 United States Code, 221(a) and 222.

[f] There are no convenience and necessity requirements for opening a stockyard or packing plant; however, the Secretary is authorized to prescribe the conditions under which persons may register and may suspend, and as to certain classes of registrants revoke, for violations.

[g] The FCC has the power to control entrance into and abandonment of interstate and foreign service by common carriers subject to its jurisdiction. Entrance into service by noncommon carriers is also controlled by the FCC in the sense that a station license must be obtained before a radio station can be legally operated. Such licenses, however, may be surrendered and the service abandoned without permission of the Commission.

[h] If the effect is to create a monopoly, manipulate, or control prices, etc.

Table 1 (*Continued*)

FPC	FCC	CAB	PSA	FMB	SEC	FTC	AD	CEA	NLRB
Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Yes	Yes	Yes	Yes	Yes	Yes	Yes, of corporations	No	Yes	Yes
Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Yes	Yes, in the case of common carriers	Yes	Yes	Yes	Yes	No	No	Yes	No
Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Yes	Yes, in the case of common carriers	Yes	Yes	Yes	No	No	No	No	No
Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	No
Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Table 2 (*Continued*)

Yes	Yes	Yes	Yes	Yes[a]	Yes, under Holding Company Act	No	No	No	No
Yes	Yes	Yes[c]	Yes	Yes[a]	No	No	No	No	No
Yes	Yes	Yes	Yes	Yes[d]	No	No	No	No	No
Yes	Yes[e]	Yes	Yes[f]	Yes[a]	No	No	No	No	No
Yes	Yes[g]	Yes	Yes[h]	Yes[i]	Yes, under Holding Company Act	No	No	No	No[j]

[i] Ownership may be controlled only as between United States citizens and foreigners. Control over management of subsidized lines must be satisfactory to Board.

[j] The regulatory powers listed in the chart do not entirely fit the operations of the National Labor Relations Board. However, the answers given describe important aspects of the Board's work in regulating a significant business relationship.

Key to Column Heads

ICC—Interstate Commerce Commission
FPC—Federal Power Commission
FCC—Federal Communications Commission
CAB—Civil Aeronautics Board
PSA—Packers and Stockyards Act (USDA)
FMB—Federal Maritime Board
SEC—Securities and Exchange Commission
FTC—Federal Trade Commission
AD—Antitrust Division (Dept. of Justice)
CEA—Commodity Exchange Authority
NLRB—National Labor Relations Board

statutory powers. The Antitrust Division decides in its own mind that certain activities of businessmen violate the law (the Sherman Act and various provisions of the Clayton Act, as amended). It thereupon brings cases, and the resulting court decisions serve as "warning flags" for competitive enterprise.

The powers of *control*, it will be seen, are exercised primarily with respect to "public utilities" subject to the jurisdiction of each particular commission. These powers are expressed, in the main, (1) in prescribing rates and charges, (2) in controlling entrance into a field or the abandonment of service, and (3) in approving or disapproving applications to expand facilities or to acquire and unify other facilities.

As a general rule, the basic purpose of commission control is to prevent extortion and to keep rates of return down to levels which presumably would exist if competition prevailed. In controlling the rates of public stockyards, for example, the Secretary of Agriculture limits charges to those which will provide a "fair return" on the value of the stockyard facilities. The provisions of the Civil Aeronautics Act, on the other hand, require a different approach. In fixing mail pay, the Civil Aeronautics Board has the duty to subsidize the industry to the extent necessary for the development of a sound air transportation industry. The Board also has the obligation to promote and develop such an air transport system not only for the purposes of commerce, but also for the national defense.

In studying regulatory authority, it is useful to consider not only the powers exercised, but also the types of companies or business activities subject to regulation. Summary statements on the types of business which are within the jurisdiction of the several federal agencies are presented in Table 3.

TABLE 3. Types of Business or Business Relations Which Are Subject to the Jurisdiction of Federal Agencies

Interstate Commerce Commission	Jurisdiction over all forms of interstate public transportation; except air carriers and pipe lines for gas and water. Controls rates for railroads, oil pipe lines; sleeping car service; express service, motor carriers; water carriers in coastwise, intercoastal, and inland-water service; and freight-forwarding companies.
Federal Power Commission	Controls licensing of hydroelectric projects on federal lands or on navigable waters of the U.S.; jurisdiction over transmission and wholesale sales of electric energy in interstate commerce and public utilities engaged therein, transportation and sale of natural gas in interstate commerce for resale and natural gas companies engaged therein.
Civil Aeronautics Board	Broad powers over interstate air commerce, generally. Jurisdiction over interstate rates (1) for the transportation of mail by aircraft and (2) for the transportation of persons and property.

TABLE 3 (*Continued*)

Packers and Stockyards Act (USDA)	Jurisdiction over (1) the rates and charges on stockyard facilities and by market agencies (livestock commission men), (2) the business practices of meat packers, and (3) the charges, services, and facilities for handling live poultry in large cities.
Federal Maritime Board	Broad powers of control over (1) American and foreign flag carriers engaged in foreign commerce and (2) the off-shore common carriers which serve U.S. territories. Authority to modify or disapprove rates, charges, fares, and trade practices.
Federal Communications Commission	Jurisdiction over interstate and foreign commerce in communications by telephone, telegraph, and radio. The Commission exercises various powers of control over standard AM, FM, and television broadcast stations, communications common carriers by wire or radio in interstate commerce (including telephone, telegraph, and cable companies), and the operators of maritime, aeronautical, land transportation, industrial, and certain other special radio services.
Federal Trade Commission	Power to prosecute unfair methods of competition and unfair or deceptive acts or practices; price and other discriminations; exclusive-dealing arrangements; corporate stock or asset acquisitions promotive of monopoly, interlocking corporate directorships promotive of monopoly—in all types of business engaged in interstate or foreign commerce, *except* banks, common carriers, air carriers, meat packers, and industries specifically exempted from the antitrust laws.
Commodity Exchange Authority	Regulatory powers over trading activity on all commodity exchanges designated as contract markets.
National Labor Relations Board	Regulates collective bargaining by unions with an employer or employers engaged in interstate commerce or in activities affecting such commerce, to prohibit unfair labor practices, to designate appropriate bargaining units, and to conduct elections for determining representatives of employees.
Securities and Exchange Commission	Regulatory powers over national securities exchanges and all brokers and dealers using the mails or other instrumentalities of interstate commerce. Regulates disclosures as to issuance of new securities sold in interstate commerce; the trading of securities on national stock exchanges; the provision of public information on listed securities, the borrowing of brokers, dealers, and members of security exchanges; the activities of investment trusts and investment advisers; the operations and conduct of all electric and gas holding companies.
Antitrust Division (Dept. of Justice)	Power to bring civil or criminal proceedings in the courts to maintain competition in all types of business, including banking, which are engaged in, or whose activities directly affect, interstate or foreign commerce, with the exception of activities specifically exempted from the antitrust laws.

LAISSEZ FAIRE AN INCOMPLETE POLICY

It is frequently said that the essence of capitalism is laissez faire or a policy of letting business alone to do as it pleases. Indeed, many persons assume that if the law declares that persons are free to compete, effective competition will automatically result and society will be assured the advantages of economic abundance. These ideas, however, are in the main illusory. Experience has shown that when business is left alone to do whatever it pleases, deceptive practices, monopolistic mergers, price fixing, and speculative excesses flourish.

A policy of laissez faire undoubtedly was effective in creating competition at the time of Adam Smith when monopolistic restrictions had their origin in governmental controls and privileges. Today, however, with giant mergers, pricing formulas, and discriminatory practices, laissez faire permits the exercise and continuing growth of private monopoly power.

Business organization, statute law, and governmental agencies are all man-made arrangements. The economic task we face is that of guiding and directing business practice so that it will promote and advance the public welfare. Professor J. M. Clark has wisely observed that

> Our system must be animated by awareness of its obligation to be directed to serviceable ends, not merely tricked by an "unseen hand" into pursuing such ends in spite of the fact that the main preoccupation of its members is with self-interested motives. . . . We can no longer rely on reaching economically correct results automatically, as an unintended by-product of what individuals do in pursuit of their private interests. We still need all we can get of such automatic adjustments; but there are growingly strategic areas in which the power of organized groups is such that, if sound terms of settlement are to be reached, people must consciously intend to reach them. This calls for some understanding of what economically correct adjustments are, and a will to promote them rather than to pursue self-interest irresponsibly.[8]

CONTINUING PLAN OF STUDY

Three principal economic imperfections of our private-enterprise system are (1) the tendency of some business enterprisers, in the drive for profits, to engage in antisocial commercial practices—such as false and mendacious advertising, adulteration of foods, misbranding of products, and the sale of harmful and dangerous goods; (2) the rise of monopoly and public grants of special privilege which benefit a few at the expense of the community; and

[8] J. M. Clark, "Aims of Economic Life as Seen by Economists," in *Goals of Economic Life* (New York, 1953), pp. 25, 50.

(3) the tendency for business activity to be cyclical, with recurring periods of boom followed by periods of depression, widespread unemployment, and social distress.

In succeeding chapters, we shall continue our study of government and business by considering the regulations which government has adopted (1) to protect consumers and (2) to create and maintain fair and effective competition in the principal areas of the economy. Thereupon, we shall study the activity of government in imposing positive controls in those sectors in which the policy of competition has proved to be ineffective or undesirable. In Chapter 23, we shall also give special consideration to monetary and fiscal policies adopted by the federal government to mitigate the problems of unhealthy booms, inflation, paralyzing depressions, and to provide for greater economic stability.

4

The Policy of Competition

The essential purpose of the various antitrust statutes is to create and maintain as far as possible, (1) freedom of entry and (2) the rule or principle of price competition as a basic mechanism for determining production, prices, and incomes. In most fields of business, competition results in more and better goods at lower prices. It moderates extreme demands in buying and selling, prevents discrimination in pricing, and develops the full economic worth of one's goods and services. These are the immediate ends or reasons for competition as a social price policy.

But more importantly and basically competition has become accepted and established as our public policy because of a belief in the dangers of concentrated power. Our political government, we stated in Chapter 2, was formulated to preserve liberty and private rights and to impose checks and balances on the exercise of political power. The policy of competition similarly has for its purpose the curbing of economic power. Professor C. D. Edwards has acutely observed that "belief in competition is the economic corollary of these political ideas. It, too, rests upon distrust of concentrated power and upon belief in the maximum possible diffusion of rights and opportunities. We are reluctant to see authority over price and production concentrated in one or a few enterprises. We want business rivalries to supply checks and balances that limit the power of each business enterprise. We want all producers and consumers to have a voice in the market decisions that affect them."[1]

A similar view on the basic importance of the policy of competition in our way of life is found in the Report of the Attorney General's National Committee to Study the Antitrust Laws (1955). In a unanimous statement the sixty members (lawyers and economists) declared:

> The general objective of the antitrust laws is promotion of competition in open markets. . . . Antitrust is a distinctive American means for assuring the competitive economy on which our political and social freedom under representative government in part depend. These laws have helped release energies essential to our leadership in industrial productivity and technologi-

[1] C. D. Edwards, *Big Business and the Policy of Competition* (Cleveland, 1956), pp. 1–2.

cal development. They reinforce our ideal of careers open to superior skills and talent, a crucial index of a free society. As a result, the essentials of antitrust are today proclaimed by both political parties as necessary to assure economic opportunity and some limitation on economic power incompatible with the maintenance of competitive conditions.[2]

Some economists and lawyers emphasize that competition is desirable for social and political reasons, without regard to its economic results. Thus, Judge Learned Hand, in his decision holding that the Aluminum Company of America had monopolistic power, said:

> It is possible, because of its indirect social or moral effect, to prefer a system of small producers, each dependent upon his own skill and character, to one in which the great mass of those engaged must accept the direction of a few. . . . We have been speaking only of the economic reasons which forbid monopoly; but, as we have already implied, there are others, based upon the belief that great industrial consolidations are inherently undesirable, regardless of their economic results. In the debates in Congress Senator Sherman, himself . . . showed that among the purposes of Congress in 1890 was a desire to put an end to great aggregations of capital because of the helplessness of the individual before them. . . . Throughout the history of these statutes it has been constantly assumed that one of their purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other.[3]

The purposes of the present chapter are (1) to explain the nature of economic competition, particularly as it is found to operate in central and primary markets, and (2) to illustrate the regulation which government exercises over competition in central markets. The conditions of market competition do not now widely exist; however, the type of competition which operates in central markets serves as a standard or yardstick for the kind of "workable," "effective," or "practically attainable" competition (never perfect) which is called for by the antitrust laws.

MEANING OF THE TERM "PRICE COMPETITION"

Webster's Unabridged Dictionary defines the word "competition" in its commercial and economic usage as "*The effort* of two or more parties, acting independently, to secure the custom of a third party *by the offer of the most favorable terms;* also the relations between different buyers or different sellers *which result from this effort*" (italics supplied).

Price competition means independent rivalry on price between two or more persons in selling or buying certain goods, each being governed by his

[2] *Report of the Attorney General's National Committee to Study the Antitrust Laws*, Washington, D.C., 1955, pp. 1–2.

[3] *U.S.* v. *Aluminum Co. of America,* 148 F. (2d) 416, 427–429 (1945).

own valuations and not restrained in his actions by any agreement or coercion. The operation of price competition *among sellers* can be observed most vividly when there is a *preponderance* of supply over demand at the going price. Sellers having lower latent valuations decrease their offers (make more favorable terms) because they want to be able to deal. They act independently and as individuals in quoting a price at which they can sell. The price so established tends to become the current price (or equilibrium price) at which transactions by other sellers are made.

Price competition *among buyers*, on the other hand, can be observed when there is a preponderance of demand over supply. Some buyer or buyers having higher latent valuations raise their "bid" prices (make more favorable terms) in order to be able to buy, and the going price moves upward to a new equilibrium level.

Price competition, in open markets, it may be noted, is not a fierce, brutal, fatal, blind, vicious, discriminatory sort of activity; nor is it a coöperative, price-matching procedure, in which rivals compete only by means of sales effort or advertising. Market competition is rather an open, aboveboard, independent, nondiscriminatory sort of rivalry *on price* which sellers or buyers engage in without fear of "retaliation." In initiating a price reduction, a seller not only secures a temporary advantage in making sales but also contributes to the making of a price at which business can be done. In the words of a long-established metal dealer, "The best of us may be wrong, but of what use to be right if we cannot deal?" Price competition operates to make a price which will equilibrate demand and supply, and promote a full employment of productive facilities.

Sellers or buyers in an open market do not exercise an influence upon market price intentionally and arbitrarily as they please, for it is determined by a balancing of market forces. Sellers, for example, cannot make some buyers pay more than the "going price" to other buyers as they can when they enjoy monopoly control in certain areas.

CENTRAL MARKETS THE IDEAL IN THE ANALYSIS OF COMPETITION

It is in central or primary markets—such as the Chicago grain market and the Boston wool market—that price competition operates most effectively and fairly as a price-making mechanism for standardized commodities. Freedom of access (or entry) is also most effectively realized, either directly or through brokers who represent customers who wish to buy. All traders are able to buy and sell under the same conditions possible to others.

When a market concourse is not fully realized—as in the case of geographically scattered cement mills—it is possible for the law to require an independent, spontaneous, nondiscriminatory type of price competition analogous to that which is found in primary or central markets. This approach and point of view were taken by Congress in the enactment of the

Federal Trade Commission and Clayton Acts, as well as by the Federal Trade Commission itself, in its attack on basing-point delivered pricing systems (see Chapter 15). The main purpose of the Robinson-Patman Act, moreover, is to require a seller to sell to various buyers at the same time at uniform prices *net* to him—as in a central market.

ESSENTIAL CONDITIONS FOR EFFECTIVE COMPETITION

The essential conditions for the existence and functioning of two-sided price competition as a price-making mechanism are as follows:

1. Freedom of entry.
2. Publicity on prices and supplies available.
3. Independent action in making bids and offers.
4. Numerous buyers and sellers.
5. A category of goods alike in kind and approximately the same in quality (see also Figure 19, facing page 164).

With the essential conditions of open markets fulfilled, two-sided price competition will develop from the desire of buyers and sellers to be able to deal. In maintaining competition, the task of government *is to maintain the conditions* which make for effective competition. As a Senate committee stated in recommending the creation of a trade commission, "It is frequently declared that the law cannot compel men employed in like business to compete with each other. There is a sense in which this is true, but it is only technically true. What is meant when we use the phrase 'maintaining competition' is maintaining competitive conditions. We can both create and maintain competitive conditions, and, until human nature is revolutionized, when competitive conditions exist there will be actual competition."[4]

INCOMPLETE KINDS OF COMPETITION

Price competition *plus* freedom of entry for potential competitors are described by various economists and antitrust experts as "effective competition," "complete competition," "market competition," or "practically attainable competition." There are also many other kinds of competition, including competition in variety, quality, salesmanship, advertising, services, and other respects.

Some economic writers and industry groups are today seeking to replace the idea of straight price competition in the sale of a certain class of commodities with that of "substitute" competition. Thus, the Business Advisory Council of the United States Department of Commerce proposes that "effective" competition be defined "as that business rivalry, existing and potential,

[4] *Control of Corporations, Persons, and Firms Engaged in Interstate Commerce*, Senate Report 1326, 62nd Congress, third session, February 26, 1913.

which tends over a period of years to serve the public interest in (a) providing alternatives and thus giving opportunities for freedom of choice of goods and services; and (b) not restricting the opportunity for others to engage in such competition."[5] In a similar way, Mr. Lilienthal describes competition as rivalry "between different ways of meeting the same or a similar need or demand for goods and services."[6] Upon the basis of these definitions, competition is seen to be provided through the choices of aluminum or copper, cigarettes or sweets.

But the great majority of people, the present writer suggests, are primarily interested in *price* competition in the sale of certain goods, rather than in competition in variety, salesmanship, services, and other respects. Anyone entering a market to buy some standard commodity prefers price competition among sellers. He then has the opportunity to buy at a lower price or on better terms. Similarly, a seller prefers to have competition on the buying prices for his class of products.

From an economic point of view, too, it is upon price competition—and freedom of entry—that a private-enterprise economy relies to insure that human skills and physical resources are allocated and used in the most efficient way.

The idea of competition as competition in variety, salesmanship, advertising, and so forth, also omits an essential feature for the determination of prices—namely, independent price competition among sellers of a given class of goods. In economics, as well as in the law, independent price competition has long been recognized as an essential condition for (1) moderating "all the traffic will bear" and (2) providing a selling outlet at which business can be done.

In a broad sense, competition of some sort is universal and everywhere. Every product is competing with something else. Always there are limits and restraints on the willingness of consumers to continue buying certain goods at higher prices. Substitute competition is clearly an important moderating force. The competition afforded by substitutes, however, does not prevent the placing of undue burdens on the public. Public policy for business enterprises calls for price competition, including freedom of entry. Other kinds of competition are inadequate and incomplete, both in economics and in the law.

COMPETITION A PRICE MECHANISM FOR STANDARDIZED COMMODITIES

The policy of competition is not applicable to all fields of commercial activity, and few persons would hold that it should be. Important areas of

[5] *Effective Competition*, Report to the Secretary of Commerce Charles Sawyer by his Business Advisory Council, Washington, D.C., December 22, 1952, p. 11.

[6] D. E. Lilienthal, *Big Business* (New York, 1953), p. 58.

exception are public utility enterprises, the sale of labor services, and agricultural production.

Competition works most effectively to determine the price of a certain class of goods which are standardized or physically homogeneous. Market goods should be alike in kind (as cocoa beans) and approximately the same in quality, for otherwise buyers will not be willing to shift to other sellers who may offer a better price, and a uniform or "going" price will not develop. It is sometimes said that in market exchange the "principle of indifference" must apply. This principle means that the various lots of a market good must be equally fit or suitable for meeting the needs of a substantial part of the buyers. It is not necessary that the goods be "perfectly homogeneous."[7]

Most, if not all, parcels of natural products—such as grains, fibers, minerals, and animals—as well as semiprocessed goods—such as hides, tallow, cheese, and molasses—differ somewhat in quality. This fact, however, does not exclude the possibility of market exchange. As long as the various lots can be used interchangeably in meeting the needs of a substantial group of buyers in a given market (and a considerable power of substitution exists), there is sufficient similarity for competitive pricing. A "going" price will be established for a given class of products; and quality differences will find expression in price differentials.

Market competition is a price-making mechanism which is primarily applicable to the sale of the basic commodities—iron, steel, copper, lead, zinc, tin, petroleum, gasoline, sugar, molasses, rice, tallow, linseed oil, naval stores, tobacco, wheat, coffee, cocoa, wool, cotton, crude rubber, cement, lumber, cheese, and canned foods. It is at this level, moreover, that the establishment of fair and equitable prices is particularly important. If all individuals can secure the basic materials of production at fair prices and without restraint, the very number of fabricating users will ordinarily insure consumer protection in the sale of highly processed, specialized articles. Various types of toothpaste, for example, are substitute products; and the competition offered by substitutes (substitute competition) is an important factor serving to prevent excessive demands by single sellers whose trademarks may give them elements of monopoly power.

TYPES OF MARKETS

Markets in which the forces of supply and demand find their greatest centralizing are called "primary" markets. These markets are "funnels" through which supplies from a large producing area—or even the nation—are concentrated for shipment to hundreds of local consuming markets. In

[7] The concepts of "pure" and "perfect" competition are useful as norms for theoretic and assumptive reasoning. However, they contain elements of perfection which do not make them practically attainable.

such cases the general level of prices for a commodity is determined by a balancing of the centralized forces of demand and supply. Prices in the local and lesser markets—in production as well as in consumption areas—are largely a reflection of the prices established in a primary market. Examples of primary market centers include the Chicago Board of Trade, the Chicago Union Stock Yards, the Boston wool market, and the New York Stock Exchange.

In many cases the products of a large production area are concentrated at

FIGURE 4. The Trading Floor of the Chicago Board of Trade Showing the Wheat Pit in the Foreground and the Corn Pit in the Background. The wheat and corn markets are primary markets of a "formal" type. (Courtesy of the Chicago Board of Trade)

a central point—as a large city—for local fabrication or use. New York City, for example, is a great consuming center for fruits and vegetables. Such market gatherings are called "central" or "terminal" markets. The concentration of supplies in a central market is usually sufficient to give it a primacy in determining prices, and prices at the various collection points or local markets are adjusted to the going price in the central market.

A market concourse may be either (1) a formally organized market—as a commodity exchange—or (2) an informal gathering of buyers and sellers. An example of a "formal" market is the Chicago Board of Trade, in which buyers and sellers are formally brought together on a trading floor (see Figure 4). Examples of "informal" markets, on the other hand, are the wool market on Summer Street in Boston; the cotton textile market on Worth Street; the Fulton Fish Market on the East River; and the fruit and vegetable market on Washington Street in New York City (see Figure 5).

Primary and central markets are sometimes called "wholesale" markets, since the goods are bought and sold in large quantities for resale. In "retail" markets, on the other hand, sales are made in small quantities to the ultimate

consumers. The best examples of retail markets are to be found in the municipal markets which most large cities maintain for the sale of local farm produce. A group of retail stores and shops in a town may be said to constitute a local market if the goods are sold under substantially the same conditions. If, however, the shops differ widely in the type of business done (such as cash and carry, credit and delivery), in the surroundings and facilities offered, or in location, buyers will not be able to compare and choose with indifference. Under such conditions, some sellers can charge

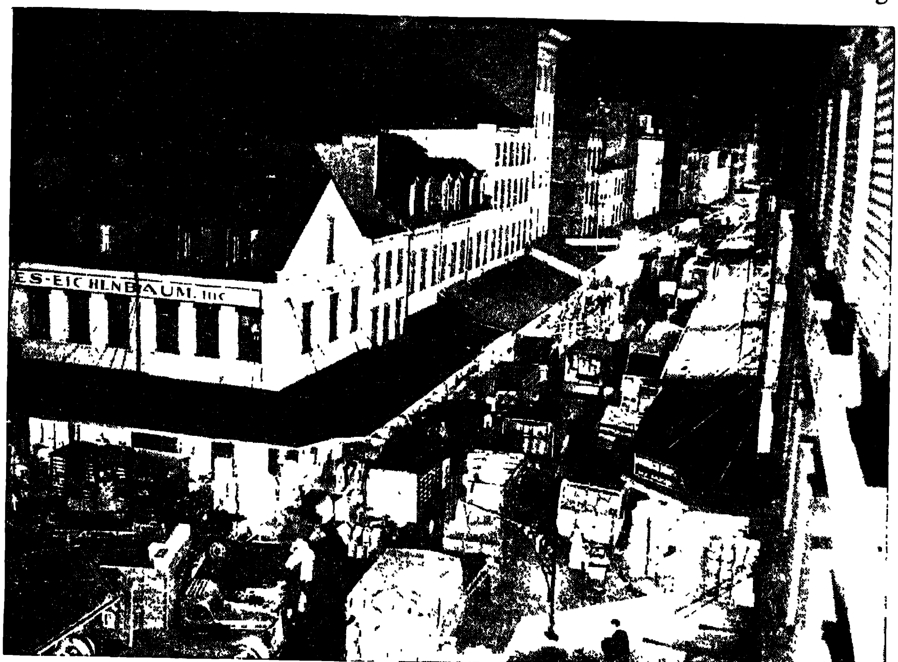


FIGURE 5. The New York City Wholesale Produce Market Located on Washington Street in Lower Manhattan. This photograph illustrates a central market of an "informal" type. The Washington Street market handles about one-eighth of all the fresh fruits and vegetables marketed in the United States. It represents the type of central produce market existing in most large eastern cities. (Courtesy of United States Department of Agriculture)

more than others and still retain a substantial group of customers. The various retail stores and shops may then be said to constitute a market only in a partial and limited sense.

GOVERNMENT REGULATION OF MARKETS

The term "free market" is frequently used to designate trading activities in which there is an absence of *direct* governmental controls on prices, sales, or credit. This concept is partially correct, but it is not complete. The idea

of free markets also includes a freedom of persons to enter the market, to have access to supplies, and to buy and sell on the same conditions as anyone else. Free markets, in this complete sense, are not self-realizing institutions. The lessons of history indicate clearly that if markets are to be free and open, government must provide rules and regulations for trading activity.

Government regulation of central and primary markets has largely taken the form of prohibiting various manipulative abuses which arise when the volume of trading is small or when market information is inadequate or misleading. Thus, the Grain Futures Act, passed by Congress in 1922, was designed to prevent manipulative and misleading practices on the organized commodity exchanges. This legislation was amended in 1936 and was given the title of the Commodity Exchange Act.

The Commodity Exchange Act authorizes the Secretary of Agriculture to perform the regulatory functions specified therein. To fulfill this task, the Secretary has established the Commodity Exchange Authority, a regulatory bureau with an administrator appointed by the Secretary. This agency supervises trading in the sixteen principal commodity markets located throughout the country (see Table 4).

TABLE 4. Principal Commodity Markets Under Federal Regulation

Chicago Board of Trade
Chicago Mercantile Exchange
Chicago Open Board of Trade
Duluth Board of Trade
Kansas City Board of Trade
Memphis Merchants Exchange Clearing Association
Milwaukee Grain Exchange
Minneapolis Grain Exchange
New Orleans Cotton Exchange
New York Cotton Exchange
New York Mercantile Exchange
New York Produce Exchange
Portland Grain Exchange
San Francisco Grain Exchange
Seattle Grain Exchange
Wool Associates of the New York Cotton Exchange, Inc.

The Commodity Exchange Act is applicable to twenty-six commodities. The commodities covered include wheat, corn, oats, barley, rye, flaxseed, grain sorghums, cotton, rice, mill-feeds, butter, eggs, Irish potatoes, wool tops, cottonseed, cottonseed meal, peanuts, soybeans, soybean meal, and fats and oil (lard, tallow, cottonseed oil, peanut oil, and soybean oil). All "futures transactions" in these commodities must be made on an exchange designated as a contract market. This rule, it may be noted, is equivalent to the medieval law against "forestalling"—that is, the purchase or sale of goods before they had reached the open market. Provision is also made for the

registration of all "futures commission merchants" and "floor brokers" dealing on the exchanges.

The Commodity Exchange Authority exercises constant watch over daily trading activities in the designated terminal markets to preserve and insure their open and competitive status. This supervision stands in sharp contrast to the absence of supervision which government exercises over the sale of primary *industrial* commodities—such as iron and steel, cement, and the nonferrous metals. In supervising the futures markets, CEA employees go to the trading floors and watch for any activity which might indicate price manipulation, corners, or "squeezes." Their objective is to prevent the development of undesirable practices and transactions, if possible. When illegal acts do occur, they collect evidence and initiate administrative or criminal proceedings.

In summary form, the chief regulatory activities of the Commodity Exchange Authority consist of the following functions: (1) to prevent price manipulation and corners, (2) to prevent the spreading of false and misleading information, (3) to protect hedgers against fraud and cheating, (4) to insure the benefits of exchange membership to cooperatives, (5) to require trust fund treatment of margin deposits, and (6) to provide information to the public on the volume of trading and open contracts to be fulfilled by delivery and acceptance. The Commodity Exchange Authority maintains five field offices, and its accountants and auditors conduct regular and special investigations to see if the provisions of the act are being observed. If violations appear to exist, charges may be filed; and the Authority is empowered to revoke "registration" as a penalty for noncompliance. If the violations are found to be criminal in nature, the evidence is turned over to the Department of Justice.[8]

REGULATION OF MARKETS FOR SECURITIES

In 1934 Congress passed the Securities Exchange Act to protect investors and the public against various abuses practiced by certain corporations, brokers, and dealers on the national securities exchanges and in the over-the-counter (informal) markets for securities. The act provides for the registration with the Securities and Exchange Commission of (1) the national securities exchanges and of all companies whose securities are listed and registered on the exchanges, (2) all brokers and dealers who are engaged in over-the-counter dealings, and (3) the national associations of security brokers and dealers. Provision is made in the act for the filing of periodic reports by all companies whose securities are listed on the exchanges, and rules are established for the disclosure of information to stockholders on proposals upon which they are asked to vote. Regulations are also estab-

[8] For additional material on the Commodity Exchange Act, see *Commodity Exchange Act, as Amended,* United States Department of Agriculture, 1958; and the annual reports of the Commodity Exchange Authority.

lished to curb the improper use of "inside" information by corporate officers and directors. The act provides for the formulation of just and equitable rules of trading and prohibits misrepresentation, market manipulation, deception, and other fraudulent practices in the sale of securities (see also Chapter 17).

DISSEMINATION OF MARKET NEWS

One of the principal services which Congress has provided in connection with the marketing of farm commodities is the Market News Service conducted by the United States Department of Agriculture in cooperation with state departments of agriculture and markets. In response to complaints from farmers and farm organizations that bids for farm products were being artificially reduced, that quoted prices were not the "going" prices, and that market supplies were being manipulated to produce gluts and low prices, Congress in 1913 provided funds for the Department of Agriculture to collect and publish useful information on the marketing of farm products. As a result of this legislation, the Department began in 1915 to issue daily market reports on fruits and vegetables, covering shipments to market centers, supplies on hand in market centers, and current market prices. In 1916 a market news service was established for the marketing of meats; in 1918, for livestock, dairy, and poultry products, as well as for hay, feed, and grain; in 1919, for cotton; in 1924, for wool; and in 1931, for tobacco.

Staff members in the market news offices secure price and sales data by checking sales slips, by interviewing buyers and sellers, and by securing reports on shipments from the railroads and trucking companies. A great deal of effort is made to get the news out to the public while it is timely. Local and central market information is transmitted to some 126 market news offices by a leased wire system. It is then released to the public through mailed reports, newspapers, radio, television, bulletin boards, personal contact, telephone, and telegraph. Market reports on various commodities are sent free of charge to persons requesting them.

At the present time, the Department of Agriculture collects and disseminates market information on prices, supplies, demand, and shipments for all major agricultural commodities in the principal central markets and producing areas. The commodities covered include livestock, meats, wool, fresh fruits and vegetables, dairy and poultry products, grain, hay, feed, cotton, cottonseed, tobacco, rice, honey, peanuts, blackstrap molasses, and naval stores.[9]

Provision to the public of information on prices, sales, and supplies is an indispensable condition for the effective functioning of price competition.

[9] Further data on the Federal Market News Service may be secured by writing to the Agricultural Marketing Service, United States Department of Agriculture, Washington 25, D.C.

It is only when buyers and sellers are well informed on market conditions that they can objectively analyze market forces and buy and sell in an intelligent manner. If government is to fulfill its declared policy of maintaining competition and preventing monopolistic practices, it should provide an adequate price- and sales-reporting system for *all* the basic commodities—industrial as well as agricultural. Various trade publications and trade associations are engaged in price-reporting activities in the industrial field, but in many instances the data either are not for public use or are not completely reliable. Since trade members and trade associations are interested parties, the reporting of price and sales statistics should be carefully regulated or handled by some quasi-public organization—such as a commodity or securities exchange or by the government itself.

DETERMINATION OF MARKET PRICE

True market price under competitive conditions is a price whose level is determined by the balancing of the forces of demand and supply—that is, the quantities of goods demanded and supplied. Its determination depends upon a centralizing of these forces as they exist over a considerable area. The centralization may be expressed either by a concourse of buyers and sellers in an exchange or by the informal grouping of dealers, brokers, and other trade interests in a certain district or along a certain street.

Before engaging in buying or selling, each trader carefully studies the statistics of demand and supply, the market news, and the prices of the last transactions. Some buyer and seller thereupon strike a bargain, and market exchange begins. The first transactions, it may be assumed, are made at $4 per unit. This fact will quickly become known to all traders either by means of a ticker tape or by some other means of price publicity. If more units are offered at $4 than will be taken at that price, some anxious seller or sellers—having lower asking prices—will thereupon decrease their offers in order to be able to deal. Thereupon a series of bargains will be made at a series of individual prices which are uniform to the customers of each seller. Between sellers, moreover, the prices tend to be uniform in any certain brief period. No one will bid above the "going price" or offer to sell below it, unless a preponderance of demand or of supply develops at that figure. The market price is said to be the "going price" because it consists of a continuing series of prices on transactions *currently* being made.[10]

The prices established in a market concourse are for the commodity in

[10] Actual data on the transactions and prices which occur in a particular market during the course of a given day may be found by consulting the reports of various organized markets. The following data from a daily report of the Chicago Mercantile Exchange are typical: "Eggs—in cents a dozen; cars of 600 cases each. Refg. U.S. Ex. No. 2—October delivery: *9:00 to 9:25 a.m.*—2 cars at 40.75; 2 at 40.80; 2 at 40.85; 5 at 40.75. *9:25 to 9:30 a.m.*—9 cars at 40.60; 5 at 40.65; 5 at 40.70. *9:30 a.m.*—20 cars at 40.75. *9:35–9:45 a.m.*—4 cars at 40.75; 1 at 40.70; 6 at 40.75," and so on during the trading period.

and at the central market. Market price is a freightless price. If delivered prices are quoted, they are f.o.b. shipping point prices plus actual freight from the place of sale to destination.[11]

SOME FEATURES OF MARKET PRICE

The price which is established by market competition may be characterized as the "going" price on actual transactions, the highest price at which market supplies find a selling outlet, and as a price whose level is influenced by supply and demand factors. Some of the features of market price which account for its being the norm and standard for public price policy are the following:

1. A market price is one which makes trade mutually advantageous to both parties. A merchant's saying, although loosely expressed, is that there is at least a 20 percent difference between the lowest amount that a seller would take and the most that a buyer would pay. This represents an advantage which an anxious seller in isolated exchange can be forced to forgo, or a necessitous buyer can be forced to pay. In an open market, however, buyers and sellers reach a compromise between their fundamentally opposite interests and establish a basis on which they may exchange to their mutual advantage. When price competition exists among sellers, excessive prices which leave buyers almost no motive to buy cannot long exist, for only a small amount of business can be done at such prices. Some sellers are willing to take less in order to be able to deal. Competition thus serves to moderate the extremer demands of various sellers and to prevent monopolistic extortion and coercion. On the other hand, when there is competition among the buyers, prices which are "too low" are quickly bid up in the scramble to make purchases.

2. The market price of each seller is uniform to all buyers at a given time, and the prices of various sellers tend toward uniformity. In a market buyers and sellers are approximately informed of demand and supply conditions and of the prices at which transactions are being made. Since transactions are made openly, no buyer will pay a given seller more than other buyers are paying. A seller, moreover, will have no reason to ask less from one buyer than from another (unless he is motivated by charity or sentiment). *The price of each seller is thus uniform to all buyers at a given time in an open*

[11] In making delivery of a commodity purchased in a formal market—such as the Chicago Board of Trade—the usual practice is to tender warehouse receipts issued by approved warehouses located in the market center. The buyer then has to pay the actual freight to destination. In informal markets prices are quoted f.o.b. the central market or f.o.b. the mill if direct delivery is made. The term "f.o.b." stands for "free on board." It means that a seller will place the product "on board" a freight car, truck, or other means of conveyance at the site of his mill or warehouse. It means also that it is up to the buyer to pay the freight. The f.o.b. price is one which is equal and open to all customers of a given seller at the same time and under the same conditions.

market. When a seller in an open market *meets* the lower offers of other sellers (made when there is a preponderance of supply over demand), he does so in order to be able to deal *at all;* and the new price so established *nets him* the same amount on *all* transactions currently being made.[12]

In an open market at a given time, *the prices of the various sellers tend toward uniformity.* It is sometimes said that the prices of various sellers in a market are *identical.* This is rarely, if ever, true. Slight differences in quality, reputation, and service rendered, especially in informal markets, may make for small price differentials among the various sellers. Within a given physical market, moreover, the location of sellers in separate shops or stalls may result in incomplete market information, and prices of the various sellers may not be fully and completely uniform. The prices of all sellers in a given market, however, are constantly tending toward uniformity because of publicity and the action of buyers in quickly turning to other sellers when prices appear to be out of line. This is the source of the doctrine, "There can be but one price in a market."

The concept of a uniform price in a market applies to a particular moment of time. Over a period of time, the current price or prices vary in a succession like a cinematic picture, with changes in the forces of demand and supply.

3. Market price is a price at which transactions can actually be made. The presence of many buyers and sellers in a primary or central market gives rise to a continuous series of transactions, and current prices are the resultant of current forces of supply and demand. If some sellers cannot secure the desired volume of sales at existing prices, they will offer to sell at lower prices. Other sellers will thereupon be forced to meet these prices in order to hold their customers. A seller's costs determine whether or not he can make a profit, but they do not determine competitive, market prices.

"All the traffic will bear" is the rule of sellers in every case, although the phrase has become associated with monopoly. It means a monopolistic price when there is a single seller or when sellers act "as one" on price. But if there is active price competition, "all the traffic will bear" as a rule will not be more than enough to afford sellers a moderate profit.

As we shall see in subsequent chapters, there are large areas of the economy in which private groups (trade associations, price leaders, cartels, and labor unions), as well as agencies of government (e.g., the Secretary of Agriculture), seek to neutralize, modify, or curb the free operation of the forces of demand and supply. Prices are managed and supplies are limited

[12] Under monopolistic conditions, a geographically separate mill with local monopoly power may charge a high mill net price in its adjacent territory and take a lower mill net on sales made in another sales area. Matching or "meeting" the price of a distant seller by absorbing freight—and taking a lower mill net *on a part* of one's sales—should be carefully distinguished from the action of a seller *acting competitively* in a market in quoting a lower price *on all of his sales* in order to meet the lower quotations which are being made by a rival. Regular and systematic price matching by absorbing freight is a special device of monopoly. See also Chapter 15.

(through price leadership, private controls, or governmental action) to secure returns above the competitive level.

SUMMARY

Competition is the established economic and legal policy for most business enterprises in the production and sale of their products. In economics, as well as in the law, the term means (1) freedom of entry and (2) independent price competition in buying and selling. The standard or ideal for competition is the kind of competition found in open markets—such as the Chicago grain market or the Boston wool market. In central markets, competition is nondiscriminatory, open, and aboveboard.

When there is no legal restraint on a person's activity in offering (or buying) goods of a given class, and no private agreement or coercion—actual or implied—among sellers (or buyers), there is possible the kind of "workable" or "effective" competition (never "perfect") called for by the antitrust laws.

Every seller, in a degree, is competing with every other seller of goods and services for the buyer's money. The universal substitution of goods, which is constantly going on, is best described as *substitute competition.* The fact that a given product (such as aluminum) touches in some directions the competition of a substitute (such as copper) does not insure protection against extortion. *Price* competition *among* sellers of a given class of goods (such as aluminum) operates more fully to moderate all that the "traffic will bear" and holds sellers to a moderate profit.

Competition among sellers in a given industry may occur not only on price, but also with respect to quality, service, advertising, sales effort, and so forth. Rivalry to give better quality or service is clearly in the public interest. There is error, however, in identifying most quality and service competition with price competition. Quality or service competition tends to change the relative quantity of sales going to each seller; it does not operate to increase *total* sales—or provide a selling outlet for larger supplies and expanding outputs.

Glossary of Terms Used with Reference to Competition in Public Policy

Effective Competition; Practically Attainable Competition. (1) Independent rivalry on price among numerous sellers; (2) the freedom and capability of others to enter the market whenever producers for any considerable period maintain a margin between price and cost which is more than enough to afford a moderate profit; and (3) market information, as accurate and complete as possible. The same conditions apply on the side of buyers.

Effective competition may occur when sellers (and buyers) are few, but it is more likely to occur when they are numerous. When rivals are few in number, parallel action on prices is likely to result, with or without explicit agreement. See also Edward H. Chamberlin, *The Theory of Monopolistic Competition* (Cambridge, 1942), pp. 46–55. Under conditions of effective competition, any given firm does not control such a large percentage of the supply of a certain class of goods that it is able to make the "going price" which as an actual fact will be largely observed in the industry.

Freedom of Competition; Freedom of Enterprise. The right of producers to follow a line of business of their own choice without interference or dictation by other producers or by government.

The terms are used to designate the freedom of enterprisers to choose a line of business, to have access to supplies, and to buy and sell on the same conditions as anyone else.

Refusal to sell products to enterprises which exercise any degree of independence on sales policies and prices, cutthroat or predatory competition, or any pressure from others restraining an enterpriser from acting in accordance with his interests, is an interference with freedom of enterprise. Licenses and other legal interferences (such as bounties and subsidies) imposed for *restrictive* purposes, rather than for revenue or for insuring competence, are a limitation on freedom of competition.

Freedom of enterprise does not mean that business firms are free to compete as they please, without rules and penalties. If competition is to be a contest of efficiency in the public interest, experience shows, there must be government intervention (1) to insure freedom of entry and (2) to prescribe and police ground rules for the conduct of competitive activity.

Perfect Competition. This term assumes perfect knowledge, perfect homogeneity, and other elements of perfection which are conceivable, but never perfectly realized. *Pure competition* is similar to perfect competition, but assumes limited market information. Both terms are useful in assumptive reasoning, but they do not provide a practically attainable standard or model for public policy. As J. M. Clark has said, we must start with the "recognition that all practicable forms of competition are 'imperfect,' and that the 'perfect competition' of economic theory is academic. Doctrinaire insistence on perfection, in competition or in antitrust policy, is a mistake" (*Guideposts in Time of Change* [New York, 1949], p. 143).

Price Competition. Independent rivalry on price between two or more persons in selling or buying certain goods, each being governed by his own valuations and not restrained in his actions by any agreement or coercion—actual or implied.

Sellers' competition moderates "all the traffic will bear," and the competitive price is lower than the price when competition among sellers is ineffective or restrained. Price competition gives rise to action on the part of some sellers to sell at lower prices than their competitors, and on the part of some buyers to buy at higher prices than competing buyers—each in an effort to increase his sales or purchases.

Workable Competition. This phrase is frequently used to designate the

concept of "Effective Competition" as discussed above. Professor Edward S. Mason defines the phrase as follows: "Workable competition is considered to require, principally, a fairly large number of sellers and buyers, no one of whom occupies a large share of the market, the absence of collusion among either group, and the possibility of market entry by new firms" (*Harvard Law Review*, June, 1949, p. 1268).

George J. Stigler gives the following definition: "An industry is workably competitive when (1) there are a considerable number of firms selling closely related products in each important market area, (2) these firms are not in collusion, and (3) the long-run average cost curve for a new firm is not materially higher than that for an established firm" (*American Economic Review*, Supplement, June 1942, pp. 2–3).

5

Business Corporations and Mergers

A striking characteristic of the American economy is the fact that a few thousand corporations dominate the principal industries. Actually, it has been estimated that some 113 of the larger industrial corporations own nearly one-half of all the net capital assets used in manufacturing. The leading corporations also exercise an even greater control over other firms by means of interlocking directorates, personal ties, agreements, and other arrangements for securing unified action.

It is mainly in the field of large, multiplant corporations that government is faced with the problem of creating and preserving competition. The realization of actual competition depends upon the creation and maintenance of *competitive conditions*. When conditions of entry are free, and sellers are numerous, the profit-seeking spirit in businessmen will usually lead to competitive behavior. The problem at hand is whether our present-day business structure provides, or can be made to provide, conditions appropriate for competition.

CAUSES OF THE CONCENTRATION MOVEMENT

What have been the causes of the vast growth of giant corporations in the American economy? One view holds that large corporations have come about as a result of a natural evolution, and that they reflect the growing demands of modern technology and national methods of distribution. Upon the basis of this view, it is held that government can or should do little or nothing to decentralize or dissolve the corporate giants.

Another view with respect to giant corporations is that they have come to replace the many thousands of independent, competing, single-plant corporations because of deliberate changes in our corporation laws. These changes have made it possible for a corporation with large financial resources to (1) hold and vote the stock of other corporations; (2) combine scores of locally separate, formerly competing plants; (3) engage in many diverse kinds of business operations; (4) form subsidiaries without limitation;

and (5) utilize the special powers of corporate organization without assuming specific obligations and responsibilities in the public interest. This view looks upon giant corporations as being largely the artificial result of unwise legislative action taken under the guidance of corporation lawyers for clients seeking greater corporation privileges. Persons taking this view believe that our present corporation laws should be changed to (1) limit the powers granted and (2) require specific responsibilities, both corporate and personal, to stockholders and the public, to match the powers conferred by charter.

The purpose of the present chapter is to analyze the nature of business corporations and to survey the action which has been taken by the state and federal governments with respect to their creation. Consideration will also be given to the factors which have made possible the present-day situation of financial mergers and supercorporations.

CORPORATIONS A CREATION OF THE LAW

A corporation is a legal entity or body which is formally created by government. Such a legal body, it has been observed, "exists only on paper" and "is a mere conception of the legislative mind."[1] As a mental conception, a corporation is clothed with such powers and privileges as the legislature may give it. The main rights granted to a corporation are the power to own property, to make contracts, to sue and be sued, to own and vote the stock of other corporations, and, usually, to have perpetual existence. A corporation itself is a very useful institution and has many advantages, both private and public. Like other human institutions, however, it may be abused by men whose final purpose is maximum business profit.

A group of persons seeking a corporate charter can now secure one through the secretary of state of a state government by paying the requisite fees and by complying with the laws of the state. Usually, the laws of the various states provide that a minimum of three persons must join in applying for a corporate charter and that a minimum of three must serve as directors. The owners of a corporation furnish the necessary capital and receive transferable shares in proportion to their contribution. Strictly speaking they—and not the corporation—are the capitalists.

A corporation is sometimes described as an artificial entity, having "neither a body to be kicked nor a soul to be damned." This description, in considerable degree, reflects the special legal status which has largely been given to corporations in the past. At the present time, the narrow, legalistic view of corporations is coming to be replaced by a more realistic view which looks upon the persons who direct the corporation as being responsible for its

[1] *People* v. *Knapp*, 99 N.E. 841, 844 (1912).

acts. A corporation, it is beginning to be seen, cannot be separated from the individuals who conceive it and who will its acts, for the legal entity itself cannot will that anything be done. A corporation is simply a legal cloak for the people who do the willing. "All its power," a federal judge has declared, "resides in the directors. Inanimate and incapable of thought, action, or neglect, it cannot hear or obey the voice of the legislature except through its directors. It can neither act nor omit to act except through them."[2] The directors of a corporation have the specific legal duty *sui generis* (unique, peculiar) of supervising the affairs of the corporation. They must (1) see that adequate provision is made for conducting the business, (2) provide

FIGURE 6. An Annual Meeting of Shareholders Called for Reporting on Corporate Activity, Transacting Certain Business, and Electing Directors. (Courtesy of Standard Oil Company, N.J.)

management to carry on the various operations, and (3) set up key committees to determine basic business decisions—i.e., investment, output, and sales policies.

Legally, *final* authority in a corporation rests with the stockholders. In the modern corporation, with its separation of ownership and management, however, stockholders are typically passive. Only a few are articulate. Rarely at the stockholders' meetings are serious constructive issues raised or discussed. Frequently, the questions asked are frivolous and superficial. Students of the modern corporation agree, however, that stockholders' meetings

[2] *Ibid.*

are essential and salutary in that they force management to face the spotlight of publicity and report openly on its stewardship (see Figure 6).

The stock of a corporation may be held by a few persons who are usually active in the conduct of the corporation's business ("close corporations"); by numerous, outside, public stockholders (publicly owned corporations); or by the government, itself (government-owned corporations). The great majority of the nation's 940,147 active corporations are in the category of "close corporations." Corporations whose securities have a quoted market are clearly in the group of publicly owned corporations. An indication of the number of such corporations may be found in the fact that some 3000 corporate stock issues are traded on organized stock exchanges. The number of over-the-counter stocks having 300 or more holders is about 4500. There are also thousands of issues with less than 300 holders which are occasionally traded in the over-the-counter markets.

COMPARATIVELY FEW BUSINESS CORPORATIONS CHARTERED PRIOR TO 1850

In granting the early corporate charters, public officials were much concerned about the privilege of continuity of existence. Individuals are mortal, and their personal accumulations of wealth and power are short-lived. Corporations, on the other hand, usually have a perpetual life. Their acquisitions of power, accordingly, may increase progressively and give them an undue political influence detrimental to the public welfare. It was for this reason that business corporations, when permitted at all, were regarded with suspicion and granted sparingly to certain types of business activity—such as banking and insurance—which require continuity of existence for their safe and successful operation. The common law also provided that corporate stock could be held and voted only by "natural persons."

In 1800 there were some 335 corporations in the United States, and most of these were enterprises engaged in operating banks, insurance companies, canals, turnpike roads, waterworks, and toll bridges. Only a few charters were granted to enterprises in general lines of business activity. The view of the legislators was that the possession of corporate charters was a privilege and not a right, and that they should be granted only to business firms having a close relationshsip to the public welfare.

Increasingly, enterprisers in general business came to see many advantages in the corporate device, and more and more requests were made to the state legislatures for corporate charters. The principal advantages which businessmen saw in the corporation were continuity of life, the opportunity to raise large sums of capital through the sale of "shares," and the privilege of limited liability. Limited liability means that a shareholder has no personal liability for the debts of the corporation, and that he stands to lose only the amount of his investment.

THE GRANTING OF CORPORATE CHARTERS BY THE STATES

Since most of the early companies requesting corporate charters were local enterprises, the state legislatures, rather than Congress, assumed the function of granting the charters. By 1850 the requests for charters had become so numerous that many states had made provision for general incorporation laws. These statutes made it possible for any group of businessmen to obtain a corporation charter simply by submitting certain information and paying a fee. The many applications for charters provided the states with a growing source of income; and in order to enhance this income, various states soon entered into a rivalry with one another for charter fees by granting increasingly liberal corporation privileges to all comers.

Since business corporations, particularly with the extension of railroad lines after 1860, increasingly came to conduct an *interstate* business, Congress had a definite responsibility to provide rules and standards for all corporations operating in interstate commerce, by requiring either federal licenses or federal incorporation. As early as 1904 the Commissioner of Corporations recommended the adoption of a "federal franchise or license system for interstate commerce," so that standards could be imposed on corporate enterprises engaged in interstate or foreign commerce.[3] There is no doubt that Congress has the power to charter or license all companies operating in interstate commerce, but to date it has enacted only special incorporation laws, as for the national banks. The strong opposition of large corporations to any legislation which would curb their privileges has been the principal factor preventing the adoption of this form of public regulation.

CORPORATIONS AND THE FORMATION OF TRUSTS

The widely increased use of the corporate device as a means for conducting business activity came at a time when the sales areas for business were rapidly being increased. Between 1850 and 1860 the rail lines of the country were extended at an unprecedented pace. In a very short time it became possible for producers in various areas—such as Pittsburgh, Chicago, St. Louis, and Philadelphia—to sell not only in their own area but also in the "back yards" of other groups of producers. Increasingly, producers who had been acting monopolistically in their local areas used their local monopoly power as a "cushion" for "cutting" prices in other sales areas to eliminate local producers or to bring them "in line" on price. Very often the larger companies or associations of producers were also able to secure discriminatory, preferential freight rates from the railroads, and these favors gave them

[3] Federal Trade Commission, *Utility Corporations*, 70th Congress, first session, Senate Document No. 92, 1934, Part 69-A, pp. 4–5.

an additional advantage over their competitors. Thus, the rapid growth of the Standard Oil Company between 1870 and 1880, it is reported, was largely made possible by the rebates and preferential freight rates which it was able to secure from the railroads.[4]

As a result of the growth of discriminatory pricing in industry, as well as by the railroads, competition after 1870 became increasingly cutthroat and chaotic. In an effort to escape the disastrous consequences of discriminatory pricing, and also to secure the private advantages of a wider monopoly control, business enterprises in various production centers formed "pools," "associations," and "loose-knit" combinations, in which they joined hands and made agreements with respect to prices and output. Continuous efforts were made to strengthen this unified action, and corporation lawyers seeking to promote the commercial interests of their clients hit upon the idea of making "trust" agreements. By this plan, the voting stock of competing corporations was assigned to a group of trustees in exchange for trust certificates. Thereupon, the trustees—a single agency—became able to hold the various enterprises securely in line on price, for a control of the corporate stock made it possible for the trustees to remove any recalcitrant plant manager at will.

The first use of the "trust" device appears to have been made by the Standard Oil Company. In 1882 John D. Rockefeller and associates formed a trust agreement with about forty companies which gave a group of nine trustees a control of 90 to 95 percent of the oil-refining capacity in the country. This control worked most effectively from their point of view. High prices and profits were secured; and with the coming of a business depression there was no price cutting or chaotic competition. Prices were maintained, although employment and production had to be sharply reduced. In competitive industry, on the other hand, prices and wages declined, production was maintained, and widespread unemployment did not develop. Similar "trusts" were formed in the production of cottonseed oil (1884), linseed oil (1885), whiskey (1887), sugar (1887), lead (1887), and cordage (1887).

THE CORPORATION BECOMES A STOCKHOLDER

The trusts had not been long in operation before legal proceedings were brought against them, and the threat of unfavorable court decisions forced corporation lawyers to search for a new method of monopoly control. This was found in the idea that corporations could be given the right to purchase and vote the stock of competing enterprises. A corporation was created by the state; and if it were authorized by law to hold the securities of other companies, it was believed that the arrangement might escape public attack.

[4] *Report of the Industrial Commission, Digest of Evidence* (Washington, 1900), Vol. 1, Part 1, p. 146.

The plan was presented to the New Jersey legislature, and in May, 1888, legislation was adopted providing that any corporation chartered in New Jersey could own and vote the stock of other corporations and issue its own stock in payment therefor. By this revolutionary act every corporation acquiring the stock of other corporations became in effect a "holding company."[5]

As was then expected, trust agreements were held by the courts to be illegal arrangements. Thereupon, soon after 1890 business enterprises increasingly turned to New Jersey to secure corporate charters granting the holding company privilege. Some of the trust leaders formed corporations to hold the stock of competing companies; other business concerns set about to control competition by buying up the stock of their competitors. Thus began the movement toward concentrated control.

THE FIRST GREAT PERIOD OF CORPORATE MERGERS: 1894–1904

Citizens and independent businessmen looked with alarm at the growing use of the holding company device to control competitors. In an effort to halt the merger movement, the federal government brought action against the American Sugar Refining Company, charging violation of the Sherman Act. This company, a New Jersey corporation, had acquired control of some 98 percent of the refined sugar capacity in the United States. The Supreme Court in 1895, however, held that "manufacturing" was not "commerce"; and that, therefore, industrial monopolies could be prosecuted only by the states (see Chapter 2, pages 25–26).

The Sherman Act was enacted in 1890 to provide *federal* intervention, for it had been found that the states either would not prosecute monopolistic enterprises or could not effectively condemn monopolies with headquarters in other states. The effect of the Sugar Trust case, therefore, was to give aggressive enterprisers seeking monopoly power a clear and unrestrained opportunity to bring scores of competitors under a centralized control.

The depression of 1893–1896 brought about a general collapse of the pools and informal agreements and gave emphasis to the merger movement. During the short period of 1894–1904, one or more corporations—usually chartered in New Jersey—were formed to acquire a control over important competing plants in the principal lines of industry. In some cases, the assets of competing plants were purchased outright, but usually a control was secured by purchasing their common stock. The use of the holding company

[5] In a strict legal sense, the term "holding company" is usually limited to a corporation which holds stock in one or more corporations and which actually exercises a control over those companies (James C. Bonbright and Gardiner C. Means, *The Holding Company* [New York, 1932], p. 8).

privilege had the advantage of enabling a corporation to secure control of other corporations without changing their organization and sometimes by acquiring only a fractional part of their stock.[6]

The industries chiefly affected by mergers during the period of 1894–1904 were petroleum, iron and steel, copper, lead, sugar, paper, linseed oil, starch, salt, powder, cans, whiskey, cottonseed oil, and coal. Some of the combinations secured a control over an unbelievably large number of separate plants. The United States Steel Corporation, for example, chartered by New Jersey in 1901, is reported to have secured a direct or indirect ownership in some 785 plants. In 1904 John Moody estimated that seventy-eight corporations controlled 50 percent or more of the production in their respective fields, and that twenty-six of them controlled 80 percent or more. Eight of the corporations—the American Can Company, the American Sugar Refining Company, the American Tobacco Company, the Corn Products Refining Company, the International Harvester Company, the National Cash Register Company, the Standard Oil Company, and the United Shoe Machinery Company—went so far in buying up competitors that they controlled some 90 percent of the output of their respective products.[7]

By the end of 1903 the big wave of merger activity largely came to a close. Most of the then important industrial concerns had been brought within the control of large financial units; and mounting public opposition to the formation of industrial giants caused business leaders for the time being to proceed more slowly. The formation of mergers was continued, however, though at a lesser pace, with most of the activity centering in banking, finance, and the public service industries.

THE SECOND GREAT PERIOD OF CORPORATE MERGERS: 1920–1929

As we shall see in Chapters 9 and 14, the government has not been effective in checking the growth of corporate mergers. In 1920, in particular, the Department of Justice lost its suit against the United States Steel Corporation, in which it had sought a court order dissolving that industrial merger. The view of the Supreme Court was that the mere size of a corporation is not condemned by law. In its decision, the Court applied the Sherman Act only to punish illegal acts—such as injuring competitors or making agreements

[6] A number of different terms have come into use to designate the various forms of combination. In our present study, the terms "merger" and "combination" will be used interchangeably to mean the acquisition of an ownership interest in former independents by a given corporation—a financial center—which gives it a complete control over the prices charged by the constituent units. A "loose-knit" combination is an association of producers which acts "as one" by agreement. See also Glossary of Terms at the end of the chapter.

[7] John Moody, *The Truth About Trusts* (New York, 1904), pp. 453, 486–487.

with them. In the eyes of the Court, there was no restraint on legitimate price competition in the combination of scores of former independents into a single financial and price-controlling unit.

The effect of the Steel decision in 1920 was to usher in a second great wave of mergers, based upon the acquisition of the stock of competitors and increasingly upon an acquisition of their assets. This second period of feverish merger activity continued until 1929, when the stock market collapse and business depression largely brought it to a close. The industries affected by the second merger movement were very much wider in scope than in the first. They included, in particular, motion pictures, petroleum, salt, fabricated copper products, automobile parts, biscuits and crackers, electrical devices, glass, glass containers, gypsum products, heavy chemicals, paper and fiberboard boxes, roofing materials, steel, meat, dairy products, bread, groceries, and drugs. Many corporate acquisitions were also made of retail stores, hotels, restaurants, movie theaters, banks, and public utilities.

During the period 1920–1929, the formation of mergers in the public utility field was especially extensive. By 1930, it is reported, about one-half of all the public utility enterprises in the country were controlled by three large holding company groups—the United Corporation, the Electric Bond and Share Company, and the Insull companies—and another 30 percent of the industry was controlled by some ten holding companies.[8]

Studies of the merger movements of 1894–1904 and 1920–1929 show that they reached their peaks during a period of rapidly rising security prices. Such periods provided a ready opportunity for selling new securities, and merger activity itself provided a means for stimulating speculative interest in securities. Many mergers, the records show, were formed by promoters—persons in a given industry and from the outside—for the purpose of securing promotional profits. In combining the various plants, the promoters increased the asset valuations and secured for themselves substantial amounts of securities for the time and assets which they contributed. The general rule on such mergers was that the whole was greater than the sum of its parts.

THE THIRD IMPORTANT PERIOD OF CORPORATE MERGERS: AFTER WORLD WAR II

Although the number of acquisitions fell off sharply after 1929, the process of corporate acquisition slowly but steadily continued. During the period 1939 to 1944, the Federal Trade Commission reports, some 832 companies were acquired by 430 corporations. A special study prepared for the Senate found that the formation of mergers was continued throughout the course

[8] Charles S. Tippetts and Shaw Livermore, *Business Organization and Control* (New York, 1932), pp. 508–509.

of World War II. "Taking manufacturing as a whole," the report states, "the giants expanded greatly, while all other firms, especially small business, suffered a substantial decline."[9]

Following V-J Day in 1945, the number of corporate acquisitions increased rapidly. Starting with the increasing trend toward mergers which began in 1940 and continuing through 1947, the Federal Trade Commission reports the disappearance of more than 2450 formerly independent manufacturing and mining companies. These firms, it states, owned assets in excess of 5.2 billion dollars, or more than 5 percent of the total assets of *all* manufacturing corporations in the country. In the main, the firms acquired during the period 1940–1947 were small firms, and the acquisitions were a less important source of growth for large acquiring firms than for small acquiring firms.[10]

Following 1949, the Federal Trade Commission reports, corporate merger activity again resumed its upward trend. Motives for the continuing growth of mergers are varied. As in the past, a principal reason is the desire of large companies to secure a greater discretionary control over prices by eliminating small and medium-sized competitors. By reducing competitive pressures, large corporations are in a position to advance selling prices and increase their profits or pass on to consumers higher taxes or wage costs. They also are able to secure a greater degree of power to reduce prices paid to suppliers.

Today, merger activity continues to center on horizontal acquisitions of companies producing or selling the same or closely related products. In many cases, horizontal mergers have been—and are being—accompanied by vertical acquisitions designed to secure a control over processing and marketing facilities. Since 1955, it is estimated that a minimum of 2657 locally operated food stores have been acquired by merger (see Table 5). The large food companies have also acquired many facilities for the growing, processing, and manufacturing of consumer products.

In some cases, additional firms have been purchased in order to diversify operations and obtain a greater stability of earnings. Owners of closely held corporations frequently have had a tax incentive to sell out to others. Their desire has been to lessen the impact of estate taxes or to take accumulated profits as capital gains. Influential stockholders and directors also have had a strong incentive to use corporate surpluses for acquiring additional plants rather than for paying dividends, in order to avoid higher personal income taxes. In other cases, corporate managements, themselves, have taken the

[9] *Economic Concentration and World War II,* Report of the Smaller War Plants Corporation, Senate Committee Print No. 6, 79th Congress, second session, 1946, p. 25.

[10] Statistics on mergers are recorded by the Federal Trade Commission upon the basis of announcements. Probably over 90 percent of the important mergers are covered in most fields. In some fields, the percentage is much lower. Annual data on the number of mergers may be secured from the Federal Trade Commission, Washington 25, D.C.

TABLE 5. Merger Movement in Retail Food Distribution, 1955–1958

	Estimated Number of Stores Acquired
George Weston Ltd.	740
Winn-Dixie	250
National Tea	178
ACF Wrigley	158
Kroger	131
Grand Union	120
American Stores	97
Colonial	91
Food Fair	71
Lucky	63
Safeway	48
Jewel Tea	43

SOURCE. National Association of Retail Grocers.

lead in expanding operations. Profits paid out as dividends, they reason, are gone forever; but retained in the business, they can be used to increase the size of the company—and the earning power of management.

Summarizing its studies of mergers, the Federal Trade Commission states:

> Mergers and acquisitions have played an important role in shaping the market structure of and the laws that govern the American economy. The early pools and trusts contributed to the enactment of the Sherman Act; the great combination wave of 1894–1904 preceded the passage of the Federal Trade Commission and Clayton Acts; the wave of mergers and acquisitions in the 1920's produced the Securities Exchange and the Public Utilities Holding Company Acts; subsequent acquisitions and mergers, especially those that occurred in the 1940's, were followed by an important revision in Section 7 of the Clayton Act.[11]

In chapters to follow, we shall study each of the acts mentioned and consider the effectiveness of this legislation in coping with the problem of economic concentration.

KINDS OF MERGERS

The rise of large corporations reflects two types of growth—internal and external. Internal growth means the expansion of existing facilities, the building of new branches, or the creation of subsidiaries. External growth, on the other hand, means the combining of formerly independent companies

[11] Federal Trade Commission, *Report on Corporate Mergers and Acquisitions*, May, 1955, p. 1.

under one central ownership. The building of new branches and the creation of subsidiaries by a parent company has been, and continues to be, an important source of "bigness" in the American economy. In the main, however, the concern of economists has centered on growth by means of mergers, for mergers mean the absorption of existing competition, the control of essential raw materials, and the consolidation of economic power.

The acquisition of smaller corporations by a larger one takes several forms. A "horizontal" merger is one which unites under one ownership *like plants* —such as cement mills—producing like products. A "vertical" merger, on the other hand, brings under one ownership a control over *unlike plants*, engaged in various stages of production from raw materials to the end product. The term "integration" is frequently used to designate a vertical merger. A third type of merger, and one which has been gaining in importance in recent years, is the "conglomerate" or circular merger. The conglomerate merger unites plants producing diverse and unrelated product lines in which the end products bear no similarity. An example of a conglomerate merger is the American Home Products Co. which has acquired control of many diverse products lines—BiSoDol, Kolynos, Anacin, Old English Wax, Three-in-One Oil, Clapp's Baby Foods, G. Washington Coffee, and so forth.

Each of the several types of mergers presents special economic problems. A horizontal merger results in the complete elimination of price competition among formerly independent and competing plants. The public is thus faced with a control over price which is stronger than that attained by conspiracy. A horizontal merger also makes it possible to exercise geographic discrimination by offsetting low prices in one area with high prices in other areas. In large measure, the problem of mergers centers in those of the horizontal type.

Vertical mergers frequently give a dominant concern a control over essential raw materials, such as iron ore, pig iron, and semifinished steel, which can be used to thwart or limit unintegrated firms making finished products. The producer possesses the basic products, and he can take whatever action he desires in their disposition. In exercising this power, the dominant concern may (1) refuse to sell to unintegrated firms or (2) take a high markup on the basic materials and a very low markup on the finished products which are sold in competition with others.

The diverse and incoherent product lines and financial size of a conglomerate merger give it a substantial power of control over single-line competitors. If a firm in a given field refuses to accept its price leadership, the combination may sell below cost in that field and offset its losses with profits from other product lines. In most, if not all cases, the dominant concern publishes only consolidated financial statements, and the practice of cutthroat discrimination may be pursued with slight fear of detection. The antitrust agencies receive numerous complaints from specialized producers that various diversified firms are using a given specialty as a "loss leader."

THE PRIVILEGE OF FORMING SUBSIDIARIES

A further factor making for corporate concentration—in addition to the acquisition of competitors—is the right of a corporation to charter new corporations to conduct operations which are being done, or which could be done, by others in the field. Such operations include those conducted by sales companies, export companies, service companies, trucking companies, processing companies, and research companies. The right of a corporation to create subsidiaries is essentially an *implied* right growing out of (1) the right to own and vote the stock of other corporations and (2) the right to engage in any field of operations.

A principal advantage in creating and owning a subsidiary corporation—rather than in owning a branch plant outright—is limitation of risk and civil liability. The damage liability which may be placed against a corporation in treble damage suits is limited to the amount of its assets; and a large corporation can reduce the risk of antitrust claims by having operations conducted by subsidiary corporations with comparatively small capitalizations. In the liquor industry, the loss of a license to a parent company is serious, but the loss to a subsidiary restricts only one outlet. Another advantage of creating and owning subsidiaries is the reported preference of some executives to work as *president* of a subsidiary corporation rather than as branch manager or divisional head! A further advantage in having subsidiaries is the fact that the controlled plants can be masked as "independents." In maintaining geographically separate plants as separate entities with different names, a parent company can avoid the public antagonism which sometimes attaches to great size. It can also use the subsidiary plants as price-cutting outlets for fighting local competition without openly revealing its own hand.

EXTENT OF ECONOMIC CONCENTRATION

In 1932 A. A. Berle and Gardiner C. Means published their highly significant study, *The Modern Corporation and Private Property*. Their investigations at that time revealed a growing corporate concentration with 200 of the largest corporations controlling some 50 percent of all corporate wealth (other than banking) and exercising an even greater domination by means of interlocking directorates, trade associations, formal agreements, secret understandings, personal ties, and other arrangements for securing unity of action on price and sales policies.[12] In most of the large corporations, Berle and Means observe, there has also come to be a separation of ownership from control. The authors distinguished five types of control: (1) control

[12] A. A. Berle, Jr., and Gardiner C. Means, *The Modern Corporation and Private Property* (New York, 1932), pp. 32–33, 40.

based upon complete or almost complete ownership, (2) majority control, (3) control by minority ownership, (4) control by legal devices—such as nonvoting stock—without majority ownership, and (5) management control without appreciable ownership (see Figure 7). In the vast majority of cases, it was found, control is now exercised either by minority ownership or by management which holds no appreciable amount of stock.

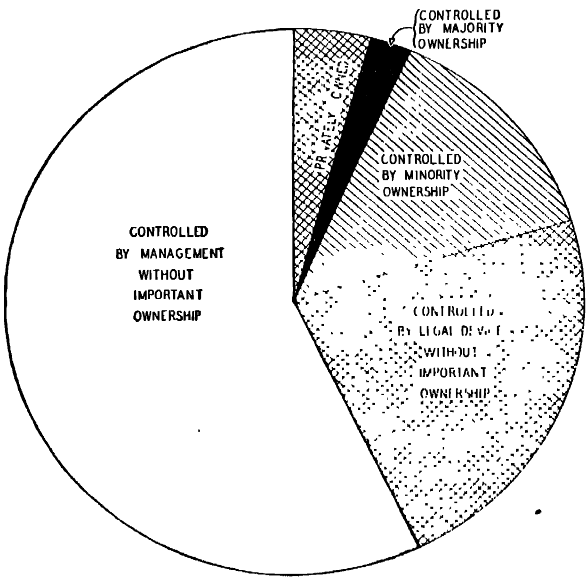


FIGURE 7. Ownership and Control of the 200 Largest Corporations, by Assets. This figure shows how ownership and control are separated in the giant corporations (nonbanking). It indicates the prevalence of private control without appreciable ownership. Today an important problem of public regulation is that of making management responsible to (1) owners and (2) consumers. (Source: Berle and Means, *The Modern Corporation and Private Property* [New York, 1932])

The very size of the corporations which have been formed, Berle and Means declare, has given rise to a condition of absentee ownership which is weakening and destroying the virtues of private property. Since stockholders are numerous and widely scattered, it is possible for management to maintain control by sending them proxy slips for use in authorizing two or three of the officers to vote their stock. At the present time, the authors state, giant corporate enterprises are in large measure run by hired managers just as in the case of a government undertaking. With the separation of ownership from control, however, the top managers in industry are largely responsible to themselves alone. Berle and Means conclude that the great problem

of government regulation is now one of making the hired managers in industry responsible not only to the owners but also to the community.

ADDITIONAL STUDIES ON CONCENTRATION OF CONTROL

A study of economic concentration for the year 1947 by the Federal Trade Commission revealed (1) that the 113 largest manufacturing corporations each had assets in excess of $100 million and (2) that these corporations owned nearly one-half (46 percent) of all the net capital assets (resources, plants, and equipment) used in manufacturing.[13] A further study published by the Commission in 1954 presented data on concentration expressed in terms of "value of product" accounted for by the 200 largest manufacturing concerns. According to this study, "in 1935 the 200 largest manufacturing corporations accounted for 37.7 percent of the total value of product of all manufacturing enterprises; by 1950 the proportion had risen to 40.5 percent."[14]

Additional data on economic concentration were prepared in 1957 by the Senate Committee on the Judiciary.[15] These data show a continuing trend of concentration in the largest manufacturing companies. In particular, in the case of the 100 largest companies, the percentage of value added by manufacture rose from 21 percent in 1947 to 30 percent in 1954 (see Table 6).

TABLE 6. Share of Total Value Added by Manufacture Accounted for by Largest Manufacturing Companies in 1954 and 1947

Company Rankings in 1954	Percent of Value Added by Manufacture, 1954	Percent of Value Added by Manufacture, 1947
Largest 50 companies	23	16
Largest 100 companies	30	21

SOURCE. *Concentration in American Industry*, Report of the Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 85th Congress, first session, 1957, p. 11.

CENTRALIZED CONTROL OVER SUPPLY IN SELECTED INDUSTRIES

A summary of the degree and character of concentration in twenty-six industries for the year 1947 is shown in Table 7. The facts show (1) that in

[13] Federal Trade Commission, *The Concentration of Productive Facilities, 1947* (Washington, 1949), p. 14.

[14] Federal Trade Commission, *Changes in Concentration in Manufacturing 1935 to 1947 and 1950* (Washington, 1954), p. 17.

[15] *Concentration in American Industry*, Report of the Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 85th Congress, first session, 1957.

TABLE 7. Concentration in Twenty-Six Selected Industries, 1947

	Percent of Net Capital Assets Owned by—						
	1 Company	2 Companies	3 Companies	4 Companies	8 Companies	15 Companies	All Companies
1. Linoleum	57.9	80.8	92.1	93.6	—	—	100.0
2. Tin cans and other tinware	55.2	92.1	95.3	96.4	—	—	100.0
3. Aluminum	55.0	85.0	100.0	—	—	—	100.0
4. Copper smelting and refining	46.8	73.5	88.5	94.6	100.0	—	100.0
5. Biscuits, crackers and pretzels	46.3	57.0	67.7	71.4	—	—	100.0
6. Agricultural machinery	45.3	56.8	66.6	75.4	82.1	—	100.0
7. Office and store machines and devices	42.0	56.3	69.5	74.3	85.3	89.6	100.0
8. Motor vehicles	40.9	62.8	68.7	70.7	77.3	86.1	100.0
9. Cigarettes	36.6	64.4	77.6	87.8	—	—	100.0
10. Plumbing equipment and supplies	33.2	64.9	71.3	74.3	—	—	100.0
11. Distilled liquors	29.0	53.3	72.4	84.6	94.3	—	100.0
12. Meat products	28.8	54.7	64.0	69.3	77.6	81.6	100.0
13. Primary steel	28.6	42.0	49.2	54.5	69.3	77.2	100.0
14. Rubber tires and tubes	27.8	49.9	70.3	88.3	94.8	—	100.0
15. Dairy products	27.5	48.9	55.8	59.6	71.3	—	100.0
16. Glass and glassware	24.9	49.1	57.4	62.2	73.9	—	100.0
17. Carpets and rugs	24.1	36.8	48.9	57.9	—	—	100.0
18. Footwear (except rubber)	23.6	39.6	43.4	46.8	53.1	57.5	100.0
19. Industrial chemicals	21.5	36.5	45.5	51.8	70.2	80.2	100.0
20. Woolen and worsted goods	16.7	23.5	28.1	30.3	36.4	—	100.0
21. Electrical machinery	15.8	28.8	41.7	47.5	55.2	60.7	100.0
22. Grain-mill products	15.6	23.5	30.2	36.3	48.6	56.6	100.0
23. Aircraft and parts	13.6	25.4	35.2	44.0	73.7	86.2	100.0
24. Bread and other products (excluding biscuits and crackers)	13.0	20.0	25.4	30.6	38.2	—	100.0
25. Canning and preserving	10.7	21.4	32.0	39.4	51.0	59.2	100.0
26. Drugs and medicines	8.4	16.5	23.5	30.0	47.7	—	100.0

SOURCE. Federal Trade Commission, *The Concentration of Productive Facilities, 1947*, p. 21

each of the selected industries a single leader is dominant and (2) that four or fewer corporations control a substantial part of the productive facilities in their respective industries. A significant section of American industry is thus characterized by oligopoly rather than by numerous independent firms.

It is possible to have independent price competition when sellers are few. However, unified selling is more likely to occur. When sellers are few, a dominant firm finds it much easier to secure a common plan of action, for there are fewer personalities to bring into line. Identical prices tend to be quoted by all sellers, either by agreement or by concurrent action in using some pricing system or formula (see also Chapter 7, pages 129–131). This is the heart or real meaning of economic concentration in a given industry.

Additional facts on economic concentration are reviewed in a study made by the Department of Commerce for the Celler Committee on the

proportion of total shipments in each of 452 industries in 1947 which was supplied by the top four companies. The study shows that in 150 of the industries studied four companies produce more than one-half of the total shipments in each industry. A summary list of industries having a high concentration of output is presented in Table 8.

TABLE 8. Concentration of Output in Largest Manufacturing Companies Measured by Value of Shipments, 1947

Industry	Number of Companies	First 4 Companies (Percent)
Primary aluminum	3	100.0
Small arms ammunition	7	99.9
Aircraft propellers	12	98.0
Telephone and telegraph equipment	50	95.7
Aluminum rolling and drawing	15	94.2
Botanical products	13	92.1
Electric lamps	35	91.8
Files	34	91.6
Locomotives and parts	33	90.7
Coal-tar crudes	13	90 6
Cigarettes	19	90.4
Electrometallurgical products	10	88.3
Petroleum and coal products	11	88.2
Flat glass	15	88.1
Tobacco stemming and redrying	93	88.0
Steam engines and turbines	15	87.6
Carbon and graphite products	36	87.1
Softwood distillation	28	85.8
Pulp goods, pressed and molded	19	85.5
Gypsum products	33	84.6
Reclaimed rubber	14	83.8
Leavening compounds	39	83.4
Matches	18	82.7
Compressed and liquefied gases	69	82.6
Safes and vaults	26	82.4
Cork products	34	81.9
Rubber footwear	20	80.7
Salt	25	80.5
Explosives	35	80.4
Hard-surface floor coverings	14	80.3
Primary copper	9	80.0
Typewriters	23	79.4
Soap and glycerine	223	79.0
Phonograph records	96	78.8
Synthetic fibers	22	78.4
Carbon black	13	78.3
Tin cans and other tinware	102	77.8
Organs	27	77.6
Graphite: ground or blended	10	77.4

TABLE 8 (*Continued*)

Industry	Number of Companies	First 4 Companies (Percent)
Corn products	47	77.2
Sewing machines	69	77.1
Tires and inner tubes	35	76.6
Primary batteries (dry and wet)	23	76.4
Wool-felt hats and hat bodies	45	76.3
Textile goods	24	74.9
Cereal preparations	55	74.9
Linseed oil mills	12	74.7
Distilled liquors, except brandy	144	74.6
Electronic tubes	32	73.2

SOURCE: *Concentration of Output in Largest Manufacturing Companies*, Department of Commerce, Washington, D.C., 1947

TABLE 9. Concentration in a Representative Sample of Industries

Industry	Percent of Value of Shipments Accounted for by 4 Largest Companies
Cyclic (coal tar) crudes	94
Typewriters	83
Primary batteries	78
Matches	74
Biscuit and crackers	71
Distilled liquor	64
Vacuum cleaners	62
Silverware and plated ware	61
Asbestos products	59
Truck trailers	57
Shortening and cooking oils	55
Flavorings	53
Collapsible tubes	52
Canned seafood	48
Electric measuring instruments	44
Cigars	44
Beauty and barber-shop equipment	42
Dental equipment and supplies	40
Flour and meal	40
Loose-leaf binders and devices	39
Leather work gloves	38

SOURCE. Irving Rottenberg, *New Statistics on Companies and on Concentration in Manufacturing from the 1954 Census*, Bureau of the Census, Washington, D.C., 1957, p. 6.

Upon the basis of 1954 census data, Irving Rottenberg, Chief, Economic Analysis Branch, Bureau of the Census, has developed statistics on concentration in a representative sample of industries. His data are shown in Table 9.

CONCENTRATION IN THE STEEL INDUSTRY

The United States Steel Corporation is called the "giant of giants." It was formed in 1901 "almost overnight" as a merger of many large steel companies which were, themselves, mergers of formerly competing plants. By 1908 it had secured control of over 50.9 percent of the ingot capacity in the United States. The substantial change in the degree of concentration in the steel industry from 1892 (before the Steel merger) and 1901 (the year of the merger) is shown in Table 10. This table shows also that the share of the nation's ingot capacity controlled by the four largest companies has changed little during the period 1901 to 1957.

TABLE 10. Concentration of Steel Ingot Capacity, 1880–1957, by Percentages

	Four Largest Producers	U. S. Steel	Next 3 Largest Producers
1880	24.8	—	—
1892	28.2	—	—
1901	61.0	47.2	13.8
1908	62.8	50.9	11.9
1920	54.5	40.1	14.4
1930	67.2	40.5	26.7
1938	64.0	35.5	28.5
1957 (first 6 months)	58.3	29.7	28.6

SOURCE: *Administered Prices—Steel*, Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 85th Congress, second session, 1958, p. 66.

It will be noted that the percentage control of the United States Steel Corporation as of 1920 began to show a decline. The Senate Committee on Antitrust and Monopoly suggests that in part this was the result of deliberate action. In the biography of Judge Elbert Gary, head of the Corporation in its early days, it was reported that

His conclusion was not to allow in any branch over 50 percent of the business and, oddly enough, it was William Jennings Bryan who set this percent for him! Along in 1906 Bryan was advocating 50 percent as the legal limit for the size of a business, and Judge Gary had seized the figure. "If we can confine ourselves voluntarily to a size approved by the most popular and trusted of radicals, we surely cannot be attacked for monopoly," he had

told his associates. They had acquiesced and had succeeded fairly well in keeping the percentage down, even in the leading products.[16]

PRODUCT CONCENTRATION IN STEEL

The steel industry is marked not only by concentration in total production, but also by concentration in particular products. This aspect of concentration is highly significant for buyers. In many market levels and in many geographic areas the choice of sellers is exceedingly limited. Thus, in Table 11, there is shown the concentration ratios for individual steel products in terms of the percentage shipments made by the four largest producers of particular products.

TABLE 11. Percentage of Net Shipments of Carbon Steel Products Accounted for by the Four Largest Producers of Each Product, 1957 (1st half)

Semifinished products:		Bars:	
Skelp	100.0	Hot rolled	71.6
Tube rounds	100.0	Reinforcing	68.6
Ingots and steel for castings	83.0	Cold finish	67.3
Wire rods	76.1	Tool steel	66.3
Blooms, slabs, billets and sheet bars	75.2	Railroad products:	
		Axels	100.0
Structural steel and plates:		Joint bars	100.0
Steel piling	100.0	Rails, standard	100.0
Structural shapes	91.6	Rails, all other	100.0
Plates	65.5	Tie plates	100.0
Sheets and strip:		Wheels (rolled and forged)	100.0
Electrical sheets and strip	100.0	Track spikes	67.1
Sheets, all other coated	100.0	Pipe and tubing:	
Hot-rolled strip	72.5	Pressure tubing	80.9
Galvanized sheets	60.9	Line pipe	64.5
Hot-rolled sheets	59.5	Standard pipe	63.1
Cold-rolled sheets	53.9	Oil country goods	59.7
Cold-rolled strip	50.7	Mechanical tubing	55.5
Tin mill products:		Wire and wire products:	
Tin and terne plate, hot dipped	87.7	Wire bale ties	78.1
Black plate	79.2	Wire, woven wire, fence	76.3
Tin plate, electrolytic	76.7	Wire, barbed and twisted	73.8
		Wire, drawn	64.6
		Wire, nails and staples	58.9

SOURCE: *Administered Prices—Steel*, Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 85th Congress, second session, 1958, p. 70.

The leadership of the United States Steel Corporation in most steel products is shown in Table 12. There are thirty-three principal steel products produced in large volume, and the Corporation has the largest capacity for twenty-two of these products.

[16] Ida M. Tarbell, *Life of Elbert H. Gary* (New York, 1925), pp. 257-258.

TABLE 12. Iron, Coke, and Major Steel Products for Which United States Steel Corporation Has the Largest Capacity in the United States, January 1, 1957

	U. S. Steel Corp. Percent of Total Industry Capacity	Percent of Industry Capacity in Next Largest Company	Difference Between U. S. Steel Corp. and Next Company (Percentage)	Items in Which U.S. Steel Corp. Is Particularly Dominant
Ingots and steel for castings	29.7	15.4	14.3	
Blast furnaces	33.9	14.8	19.1	X
Coke ovens	31.6	15.7	15.9	
Products:				
Finished hot rolled:				
Rails, standard	50.1	21.9	28.2	X
Long-joint or splice bar	46.3	21.1	25.2	X
Plates, sheared	42.9	11.1	31.8	X
Hot-rolled sheets	21.2	15.2	6.0	
Hot-rolled strip	20.1	18.9	1.2	
Coils for cold reduced black plate and tin plate	31.7	26.0	5.7	
Bars, other than concrete reinforcement	23.0	22.0	.1	
Wire rods	39.0	10.9	28.1	X
Blanks, tube rounds, etc.	42.8	11.1	31.7	X
Other steel mill products:				
Pipe and tubing:				
Buttweld	25.3	14.7	11.6	
Seamless	41.4	9.8	31.6	X
Galvanized	25.5	16.6	8.9	
Wire and wire products:				
Plain wire	32.0	9.8	22.2	
Galvanized wire	35.7	12.3	23.4	X
Nails and staples	41.9	9.7	32.2	X
Barbed wire	41.3	10.7	30.6	X
Woven fence	27.3	22.8	4.5	
Sheets: Galvanized	21.4	16.8	4.6	
Tin mill products:				
Hot-dipped tin and terne plate	51.9	19.7	32.2	X
Electrolytic tin plate	31.4	18.7	12.7	
Black plate	44.8	18.6	26.2	X
Tie plates	54.2	24.0	30.2	X

SOURCE: *Administered Prices—Steel*, Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 85th Congress, second session, 1958, p. 71.

INTERLOCKING DIRECTORATES AS A DEVICE FOR RESTRICTING COMPETITION AND ARM'S-LENGTH BARGAINING

Interlocking directorates are a major device used in business for restricting competition and for securing preferred access to customers or supplies. The term itself means that a given person serves as a director on the boards of two or more corporations. In this capacity, he "interlocks" the deliberations of the two concerns (see Figure 8).

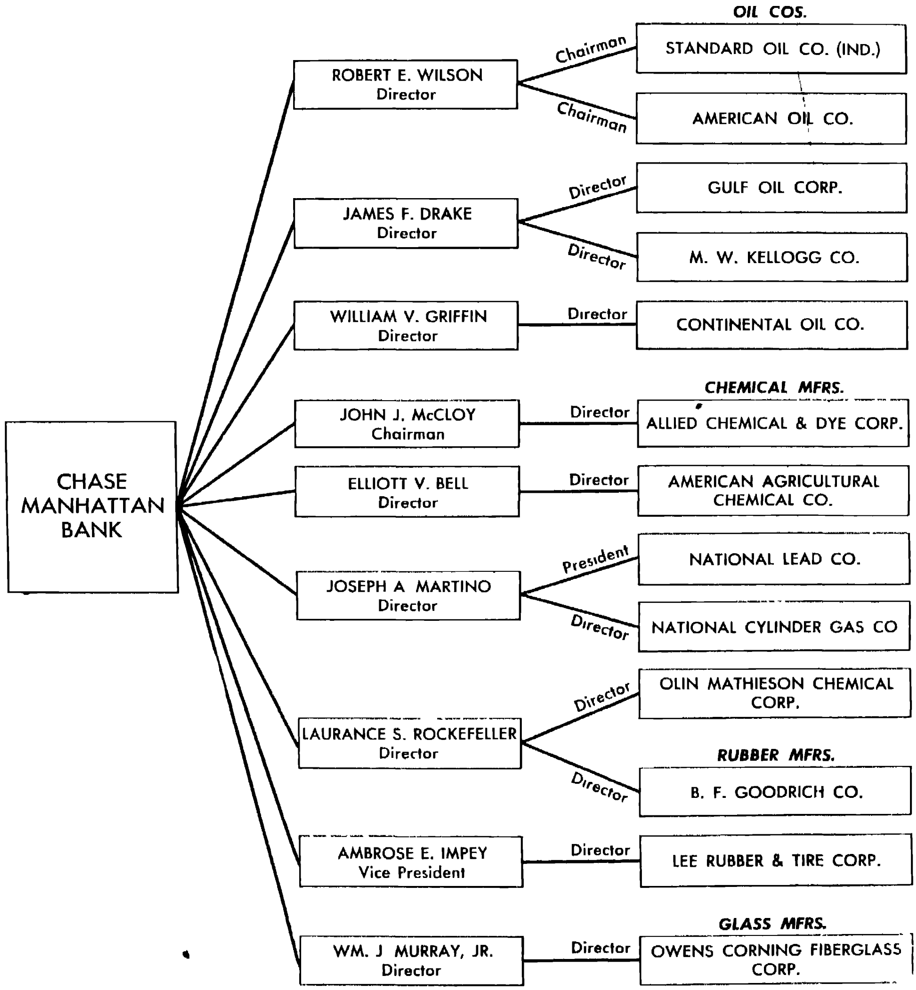


FIGURE 8. Interlocking Directors and Officers of Chase Manhattan Bank with Major Oil, Chemical, Rubber, and Glass Companies, 1956. (Source: Select Committee on Small Business, House of Representatives, Report 2718, 85th Congress, second session, 1959)

Interlocking relations between corporations also result when an *officer* of a given corporation (not a director of that corporation) serves as a director of a concern which is a rival, customer, or supplier. Frequently, moreover, corporate enterprises are tied together by "indirect" interlocks—that is, by directors (or officers) who meet together on the board of a third corporation.

Interlocking directorates (or relationships) are a much more effective device for securing unified selling and commercial favors than dinners, telephone conversations, or trade association meetings. In attending the board meetings of another corporation, a particular executive can listen, hear, and examine closely its procedures. He has a ringside seat which permits him to learn the most intimate details of the other's business at the very time that crucial decisions are being made.

A person serving on two or more boards frequently owns little stock in the various concerns which he interlocks. He gets his position, in other words, for reasons other than the number of shares which he votes at a stockholder's meeting. How is the interlock effected if not by substantial stock ownership? Usually, a director (or officer) of a given concern is elected to serve by the dominating person on the other board. The dominating person or key executive promotes the interlock for a number of reasons. In electing a person to serve on the board, and in giving him a ringside seat, the key executive surrounds himself with men whom he can control. In meeting and working intimately with them, moreover, he and they are in a position to effect reciprocal trading favors, such as the exchange of "inside" information on investment opportunities.

Interlocking directorates are sometimes used among rival firms to work out the details of a price-fixing plan. The periodic meetings of directors thereupon provide an effective means for supervising its operation. Interlocking arrangements are also used between suppliers and customers. A dominant seller (industrial concern or bank) may find an advantage in electing a director from an important *customer* in order to secure preferred access in selling, in placing loans, or in unifying the relations of customers who are competitors. The director of the customer concern, on the other hand, finds an interest in the personal favors and corporate advantages which may be secured in working on the other board. Likewise, an important buyer may seek out a director from a key supplier (to insure supplies), and the invitee may accept the directorship for personal trading purposes, inside information, and personal financial power.

The Federal Trade Commission in its report on *Interlocking Directorates* (1951) states: "Interlocking directorates between buyers and sellers are inconsistent with the arm's-length dealings that prevent favoritism and assure equal access for other enterprises. . . . An interlocking directorate between an industrial corporation and a bank may establish preferential access to credit for the industrial corporation."

Interlocking relationships have long been condemned by socially minded

lawyers, businessmen, and economists as (1) restrictive of competition between and among competitors and (2) inconsistent with arm's-length dealing which permits free choice and equal access for other concerns. Mr. Louis D. Brandeis, later Justice of the United States Supreme Court, was a leading critic of business interlocks, and his writings during the years 1913–1914 were an important factor in leading to the adoption of federal legislation limiting —but not preventing—their use (see Chapter 14, page 327). In an article entitled "The Endless Chain: Interlocking Directorates," Mr. Brandeis declared:

> The practice of interlocking directorates is the root of many evils. It offends laws human and divine. Applied to rival corporations, it tends to the suppression of competition and to the violation of the Sherman Law. Applied to corporations which deal with each other, it tends to disloyalty and to violation of the fundamental law that no man can serve two masters. In either event, it tends to inefficiency; for it removes incentive and destroys soundness of judgment. It is undemocratic, for it rejects the platform: "A fair field and no favors"—substituting the pull of privilege for the push of manhood.[17]

The Clayton Act (1914), in particular, imposes various limits and restrictions on interlocking directorates. However, as we shall show more fully in Chapter 14, the law is incomplete and easily evaded.

SUMMARY

Vast financial size in corporations has come about largely through (1) the merger of formerly independent plants, (2) the building of branch plants, and (3) the creation of subsidiaries. Extreme corporate concentration has been greatly facilitated by the action of state governments in granting charters which contain holding company privileges. It has also been accentuated by the willingness of the states to grant charters permitting corporations to engage in more than one kind of business and to form subsidiaries without limitation. There is error in identifying the rise of giant corporations with the needs of modern technology and mass production. Corporate concentration and financial bigness, the evidence indicates, have arisen primarily from (1) the drive of various business groups for the added profits of centralized control and (2) the failure of the federal and state governments to establish standards for the operation and conduct of business corporations.

Very few public problems arise in the case of single-plant corporations which are managed or controlled by their owners. It is rather in the existence and operation of supercorporations (or giant mergers), acting in unison through interlocking arrangements and other ties, that the principal social,

[17] Louis D. Brandeis, "The Endless Chain: Interlocking Directorates," *Harper's Weekly*, December 6, 1913, p. 13.

economic, and political evils arise. With the separation of ownership from management, it is possible for small minority groups, responsible to no one but themselves, to control immense aggregations of "other people's money." In many cases, these centralized powers of control have been used against the interests and rights of the actual owners, as well as against the welfare of the public. In many areas, moreover, corporate concentration has meant the elimination of price competition among scores of formerly independent plants.

Glossary of Terms Used with Reference to Business Organization

Affiliate. An affiliate is a corporation in which a larger corporation has an ownership interest. The stock ownership may be complete (100 percent) or fractional (5 percent or less).

Amalgamation. This term is used to mean (1) the proprietary union—or the fusing of ownership—of two or more enterprises into a *new* corporation and (2) the dissolution or liquidation of the formerly existing corporations.

Combination. The terms "combination" and "merger" are commonly used interchangeably.

Consolidated company. This term is used in an accounting sense. It is a corporation controlled by a larger corporation (usually 50 percent ownership or more), whose accounts are consolidated with those of the larger corporation.

Consolidation. A broad term which is used to mean (1) the acquisition of one or more smaller corporations by a larger one (merger) or (2) the proprietary union of two or more enterprises into a *new* business organization or corporation (amalgamation).

Cooperative marketing association. A group of producers associated together to process, handle, and sell their products (and also to purchase supplies) without competing against one another. A producers' cooperative usually provides for a sharing of "patronage refunds" (net margins above expenses and reserves) in accordance with the amount and quality of products sold by each member through the association. Approximately 80 percent of the cooperative marketing associations are organized as corporations.

Cooperative marketing associations of (1) agricultural producers and (2) producers of aquatic products are exempted from the antitrust laws. All other associations of business enterprises for marketing their products "as one" are illegal under the antitrust laws as a restraint on competition.

Cooperative *purchasing* agencies (including "consumer" cooperatives) owned by a number of individuals or business firms embrace the cooperative principle. They are not, however, cooperative associations for marketing the products of their members. Cooperative purchasing arrangements are a legal form of organization.

Division. This term is used to designate a segment of a given corporation's

operations. Thus, Carter Oil is a division of the Humble Oil and Refining Company, a subsidiary corporation of the Standard Oil Company (N.J.).

Holding company. In principle, any corporation which owns stock in other corporations is a holding company. In a strict legal sense, however, the term is usually limited to a corporation which holds stock in one or more corporations and which actually exercises a control over those companies.

Loose-knit combinations. Various forms of associations with respect to prices and output based upon agreement rather than ownership. They range from simple agreements to formal "pools" which provide for a sharing of output, sales, or earnings. An association of firms for the purpose of agreeing on price and controlling supply is also called a "cartel." Loose-knit combinations are illegal, per se, under the federal antitrust laws.

Merger. The acquisition of one or more smaller corporations by a larger one—that is, the union of two or more enterprises under one ownership. In some cases, the acquired corporation is permitted to keep its identity; and in other cases, it is dissolved and its assets are transferred to the corporation which survives. The ownership interest possessed by the acquiring corporation may be complete or fractional—the essential degree of ownership is that which gives control over the constituent units.

Subsidiaries. A "subsidiary" corporation is a corporation controlled by another corporation through complete or fractional stock ownership. A corporation secures subsidiaries by (1) acquiring the stock of a formerly independent corporation or (2) chartering an entirely new corporation.

6

Big Business and Public Policy

A distinctive feature of the American economy is the existence of a comparatively few large corporations (1) controlling a large share of the output in particular industries and (2) exercising in certain situations discretionary power over price and entry. Various persons describe the problem in different ways—concentrated control, disproportionate economic size, dominating power with anticompetitive effects, corporationism, and supercorporationism. Prices in the areas of concentrated economic power, it is pointed out, are no longer determined automatically by the forces of supply and demand. Rather, they reflect private discretionary control, tempered by the rivalry of substitute products. From the standpoint of the public, the issue is what policy should be adopted with respect to this power.

Much confusion has arisen in the discussions of business size because various persons have divergent ideas on the meaning of the terms "large business," "bigness," "size," "mass production," and "efficiency." Do the "economics of size," for example, relate to (1) a single physical unit—as a sugar mill at a single definite location—or (2) various kinds of combination in which a single corporation owns or controls a number of separate plants, dispersed in geographical location, and differing in size, technical equipment, and kinds of goods produced?

THE ECONOMY OF MASS PRODUCTION

In studying the economies of size it is essential to distinguish between (1) large *technological* size in a single factory, plant, or works—such as a steel mill or chemical works—at a specified location; and (2) large *financial* size in the centralized ownership or control of a collection of geographically separate plants.

Economists have long observed that *up to a certain limit* increasing the size *of a single plant* brings lower average unit costs. The main advantage of large size in a single factory arises in the mass production of one or a few products. Mass production means turning out a large quantity of a particular

kind of product, such as assembled automobiles, rubber tires, or cement. In summary form, the source of the economies of mass production may be listed as follows:

1. Division of labor and specialization in particular operations. Economies include increase of skill, saving of time in changing from one operation to another, and the use of workers having limited experience and training. In a large meat packing plant the various labor tasks are divided into as many as 1100 different jobs.

2. The continuous use of large, specialized machines and facilities, and assembly-line methods of production. It is reported that a forge shop in the United States will produce up to 400 percent more forgings per hour than a shop in England because American shops are more spacious, the furnaces are larger and better, and mechanical handling is more highly developed.[1]

3. The economies of large-scale buying and selling. Savings arise (1) in the purchase of carload and shipload quantities, and (2) in spreading selling and advertising costs over a larger output.

4. Economies secured in the physical integration, i.e., the adding or uniting of successive processing steps within a factory. A steel fabricating mill or forge works, for example, may find economies in adding an electric furnace to produce its own ingots. A steel mill making basic products likewise may expand by adding facilities for producing finished products and specialities. The uniting of several processes—or shops—in a single factory yields economies in the continuity of productive operations, in the saving of fuel and transportation costs, in buying and selling in larger quantities, and in having more assured buying and selling outlets.

LIMITS TO THE ECONOMY OF SIZE

Beyond a certain point, greater size in a single plant brings disadvantages and results in higher unit costs. The limits to the economical size of a plant are governed by a number of factors:

1. Maximum economies in a single plant are usually secured when a plant utilizes fully the best available and most efficient machines, processes, and assembly techniques. Little, if any, additional economy can be secured by a duplication of such facilities.

2. Auxiliary processes which a plant might add, such as power generation, may be more economically conducted as a separate large-scale operation by another company.

3. Labor tasks for a given operation, such as meat packing, cannot be continuously and indefinitely subdivided.

4. Available supplies of raw materials, livestock, labor, power, and water resources may not justify a larger operation.

[1] International Labour Organization, *Factors Affecting Productivity in the Metal Trades* (Geneva, 1952), p. 32.

5. Experience shows that management itself finds it increasingly difficult to supervise, coordinate, and control the diverse phases of a business enterprise whenever it grows beyond a certain size. Management's efforts become diluted and relatively inefficient. A centralized office cannot effectively win and maintain personal contacts with distant customers. Local, on-the-spot companies have an advantage in dealing with nearby customers.

6. The increasing costs—freight, icing, shrinkage, spoilage—of transporting finished products to scattered buyers at greater distances directly limits the size and output of a given plant. In general, the farther that products are shipped, the higher the delivered costs. Every plant, it has long been observed, is a "zoned business," that is, a business which has a natural sales area beyond which it cannot economically ship.

7. Large, single-product plants are particularly vulnerable to changes in local conditions of supply and demand. A farming region currently producing substantial supplies of hogs, for example, may suddenly shift to the production of sugar beets, fruits, or vegetables.

THE ECONOMY OF MASS PRODUCTION IN SINGLE PLANTS SHOULD BE PERMITTED TO DEVELOP FULLY

There are many large single factories in the American economy which undoubtedly develop in marked degree the advantages of mass production—or the economy of large production. These plants are illustrated by some of the large automobile assembly plants, airplane establishments, oil refineries, steel mills, cement mills, and chemical works.

No critic of big business proposes or advocates that the size of a single physical plant be limited, restricted, or reduced in any way. Indeed, it is clear to all that governmental policy should accommodate itself to the largest plants which are necessitated by existing or prospective technology.

THE CONCEPT OF BIG BUSINESS

The term "big business" is used to mean a financially large corporation which (1) owns outright or controls many geographically separate plants *and* (2) produces a substantial share of the output in a given industry, such as aluminum, cigarettes, or electric machinery. The term is also applied collectively to the 100 or more largest corporations which own or control a substantial part of all corporate assets (see Table 13). Business concerns which do not meet these tests need not, in fact, be small in terms of assets or specialized operations. For example, a "small" company operating blast furnaces in the iron and steel industry is, of necessity, a large multimillion-dollar company. Likewise, many companies are small in comparison with many big concerns, but they are big in their own speciality fields.

TABLE 13. Ranking of the 120 Largest Manufacturers, by Assets

Company	Assets	Company	Assets
Standard Oil Co. (New Jersey)	1	National Steel Corp.	48
General Motors Corp.	2	Union Oil Co. of California	49
United States Steel Corp.	3	Continental Can Co.	50
Ford Motor Co.	4		
Gulf Oil Corp.	5	Sun Oil Co.	51
Socony Mobil Oil Co.	6	Youngstown Sheet & Tube Co.	52
Texas Co.	7	Monsanto Chemical Co.	53
E. I. du Pont de Nemours & Co.	8	Continental Oil Co.	54
Standard Oil Co. (Indiana)	9	United States Rubber Co.	55
General Electric Co.	10	American Cyanamid Co.	56
		Pittsburgh Plate Glass Co.	57
Bethlehem Steel Corp.	11	General Dynamics Corp.	58
Standard Oil Co. (California)	12	Crown Zellerbach Corp.	59
Phillips Petroleum Co.	13	Weyerhauser Timber Co.	60
Chrysler Corp.	14		
Sinclair Oil Corp.	15	National Dairy Products Corp.	61
Union Carbide Corp.	16	Swift & Co.	62
Shell Oil Co.	17	Sunray Mid-Cont. Oil Corp.	63
Westinghouse Electric Corp.	18	Pure Oil Co.	64
Western Electric Co.	19	B. F. Goodrich Co.	65
Aluminum Co. of America	20	Burlington Industries, Inc.	66
		Distillers Corp.—Seagrams, Ltd.	67
Cities Service Co.	21	Caterpillar Tractor Co.	68
Internat. Bus. Mach. Corp.	22	Boeing Airplane Co.	69
Anaconda Co.	23	Deere & Co.	70
International Harvester Co.	24		
Republic Steel Corp.	25	Allis-Chalmers Mfg. Co.	71
Goodyear Tire & Rubber Co.	26	W. R. Grace & Co.	72
Dow Chemical Co.	27	Nat'l Dist. & Chem. Corp.	73
International Paper Co.	28	Liggett & Myers Tobacco Co.	74
American Tobacco Co.	29	United Aircraft Corp.	75
Kennecott Copper Corp.	30	Singer Manufacturing Co.	76
		Kaiser Steel Corp.	77
Procter & Gamble Co.	31	General Foods Corp.	78
International T. & T. Corp.	32	Armour & Co.	79
Jones & Laughlin Steel Corp.	33	Phelps Dodge Corp.	80
Tide Water Oil Co.	34		
Olin Mathieson Chemical Corp.	35	Lockheed Aircraft Corp.	81
American Can Co.	36	Owens-Illinois Glass Co.	82
Firestone Tire & Rubber Co.	37	Borg-Warner Corp.	83
Eastman Kodak Co.	38	Amer. Smelt. & Ref. Co.	84
Allied Chemical Corp.	39	Douglas Aircraft Co.	85
Radio Corp. of America	40	Schenley Industries, Inc.	86
		Ohio Oil Co.	87
Atlantic Refining Co.	41	Standard Oil Co. (Ohio)	88
Sperry Rand Corp.	42	St. Regis Paper Co.	89
Kaiser Alum. & Chem. Corp.	43	Bendix Aviation Corp.	90
Reynolds Metals Co.	44		
Armco Steel Corp.	45	Skelly Oil Co.	91
R. J. Reynolds Tobacco Co.	46	Richfield Oil Co.	92
Inland Steel Co.	47	National Lead Co.	93

TABLE 13 (*Continued*)

Company	Assets	Company	Assets
Borden Co.	94	United States Gypsum Co.	108
North American Aviation, Inc.	95	Colorado Fuel & Iron Corp.	109
Celanese Corp. of America	96	Food Mach. & Chem. Corp.	110
General Amer. Trans. Corp.	97		
J. P. Stevens & Co.	98	Minnesota Min. & Mfg. Co.	111
Colgate-Palmolive Co.	99	California Packing Corp.	112
Scott Paper Co.	100	Burroughs Corp.	113
		American R. & S. San. Corp.	114
Kimberly-Clark Corp.	101	National Cash Register Co.	115
Curtiss-Wright Corp.	102	American Metal Climax, Inc.	116
Philip Morris, Inc.	103	General Tire & Rubber Co.	117
Campbell Soup Co.	104	American Viscose Corp.	118
Mack Trucks, Inc.	105	Johns-Manville Corp.	119
Coca-Cola Co.	106	United Mer. & Mfrs., Inc.	120
Wheeling Steel Corp.	107		

SOURCE: *Conference Board Business Record*, April, 1959, p. 187.

THE CASE *FOR* BIG BUSINESS

The arguments presented in defense of big business are found not only in the statements and writings of business leaders, but also in the works of various theorists who have developed a rationale for concentrated business power.[2] Persons presenting the case *for* big business typically marshal their arguments to develop two main theses: (1) that big business is the indispensable dynamic factor in the preservation and continued improvement of our high level of living and (2) that bigness in business is an inherent factor in certain types of business and is here to stay. A summary of these arguments may be stated as follows:

Big Business Is Actively Competitive

Big business firms are competitive in offering many inducements to buyers to cause them to deal. Rivalry may consist of inducements in quality, terms, services, or price. Today the character of competition is such that it is frequently the customer rather than the producer who exercises any measure of control over price. This is so because the alternatives from which he may choose have been multiplied by technical developments. If a producer should be unmindful of his customers' needs, he would soon face competition from

[2] A number of writers have developed a defense for big business. Their views are analyzed in detail in C. D. Edwards, *Big Business and the Policy of Competition* (Cleveland, 1956), pp. 15–26.

unexpected sources in unlike materials performing the same function. The whole matter of substitute competition has become increasingly important as our technology advances.

The results of competition are shown by our high productivity and technical progress. According to the National Association of Manufacturers, for example,

> The result of effective competition is growth and progress, with a continual increase in the output of goods at continually lower prices. . . . By this overall criterion there can be no doubt that the United States has enjoyed the advantages of aggressive competition. The growth of the economy, the constant appearance of new products, the increase in output of goods, and the constant improvement of the standard of living, are all evidence of this fact. Whatever may happen in the future, there is as yet no sign that business concentration, by destroying competition, has brought our economic progress to an end.[3]

The Economy of Large-Scale Management

Greater efficiency is secured through superior and large-scale management. A multiplant company is financially able to employ the very best managerial talent to supervise, guide, and counsel the heads of subsidiary plants. In the view of Professor J. A. Schumpeter, the "better brains" which are available to large units are the "outstanding feature" of large business size.[4] A large firm, moreover, can divide managerial functions into numerous specialized operations and employ experts for each department. Further, the services of a specialized department, such as sales forecasting, can be utilized by the several branches of a multiplant firm. The per-unit cost of large-scale management in multiplant companies is typically low because management overhead can be spread over a large output.

Advantages in Large-Scale Buying and Selling

Big companies have advantages in large-scale buying. Quantity buying makes possible numerous savings in manufacturing, selling, packaging, packing, shipping, billing, and collecting. Many large buyers are able to secure substantial quantity discounts as a result of such savings, and these discounts are passed on to the public in the form of lower prices. Lower costs may also be obtained through better performance in the market in ferreting out "good buys," i.e., in finding where prices are out of line and in taking advantage of special buying opportunities.

[3] National Association of Manufacturers, *Business Size and the Public Interest*, Economic Policy Division Series No. 18, November, 1949.

[4] J. A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York, 1947), p. 101.

Large company size likewise brings advantages in large-scale marketing. Such advantages arise (1) in having a more complete product line and (2) in having a larger volume of each item within a line to sell. When the volume of sales of a given item is large, a company is able to engage in national advertising which *may* be the cheapest form of selling. The large volume of sales makes it possible to decrease the overhead advertising expense per unit of sale. Unit costs of marketing can also be substantially reduced by spreading the cost of a sales organization over numerous products. Some of the large meat packers have acquired additional plants in order to build up a line of products—fresh meats, poultry, dairy products, margarine, and peanut butter—for their sales units and distribution facilities to handle.

Large Size Makes Possible the Most Advanced Technology

Large companies, representing a large and varied organization, and having a great number of scientific specialists, are in a position to develop and implement the most advanced technology. Electronic accounting, electronic automation in manufacturing, and the development of new products are "big spoon" operations which require large financial investment. One of the more important innovations in the chemical industry, for example, has been the development of the continous process, operating twenty-four hours a day, based upon automatic control. Automatic control is a complex of instruments which assembles information and transmits "instructions" to devices which regulate the various processes of production. Today, an entire chemical process, such as the making of nylon, can be largely regulated by automatic controls which govern the temperatures, pressures, constituents, and flow of materials.

To an increasing extent, automatic controls are serving to transform industrial production. They make it possible to produce high-quality products, in large volume, with very much less labor, with less hazard (as in atomic energy units), and with far greater precision, than is possible with human control. Competent engineers believe that only a beginning has been made in the technology of automatic control. Its full potential, they say, rests with the future.

The development and implementation of automatic control programs in large-scale production are dependent upon a large organization which has great numbers of scientific specialists, as well as vast amounts of capital. Modern processes, as in synthetic fiber and atomic energy installations, are exceedingly complicated and complex. In developing technology for these processes, and in applying automatic controls to it, knowledge and experience must be drawn from many branches of science. At the present time, du Pont employs technical people in some 160 different branches of science. This vast reservoir of knowledge, it has been found, is a necessary basis for developing and implementing continuous-process production based upon automatic control.

Advantages in Conducting Research

Big business units are financially able to support large research laboratories. Industrial research is expensive—the average cost of research and development facilities per scientist is about $27,000. A concern is lucky, moreover, if one research project out of ten actually results in increased sales revenue. Some large companies, such as du Pont, suggest that a ratio of one to twenty is much more realistic. Large companies have an advantage over small companies to the extent that they can afford this sort of investment. Large companies can support research teams which permit an efficient attack on complicated problems. The research work, moreover, can be directly tied to the needs of the operating departments.

In the research field, the element of diversification has become increasingly important. Experience in a number of fields broadens the commercial background against which new developments can be evaluated. Du Pont reports, for example, that it is highly unlikely that its research in the high polymers would have produced a synthetic textile fiber if the company had not previously entered the rayon business and acquired a working knowledge of the textile field. A diversified structure helps to diminish the long odds of successful research operation. It also provides a broader base for developing discoveries which are not consciously sought (serendipity).

In most cases, research cannot be hurried, and frequently a number of years must be spent in developing a new product or process. It took twenty-five years, for example, to develop the production of aluminum on a practical basis. Eleven years were required from the beginning of fundamental research on giant molecules to the first commercial production of nylon. In developing nylon, du Pont invested not only great effort and patience, but also vast sums of money. Swift and Company spent nearly ten years of time and much money in developing a process for converting lard into a bland, hydrogenated shortening which can be used for cakes and pastries. In the oil and chemical fields, it is reported that if the research staffs of large companies are able to get a basic development once every five years, the top management believes that its research expenditures are fully justified.

At the present time, large corporations do not use their laboratories to "fence in" or "block" new fields of enterprise. Many large firms, such as du Pont, deliberately grant favorable licenses to promote competition with their own business.

Advantages in Uniting Successive Processes in the Production of Goods

The acquisition or ownership of plants at successive stages—such as production, refining, and marketing in the oil industry—may be highly desirable in order to get (1) an assured source of supply, or (2) an assured selling outlet, as the case may be. It is very difficult, for example, to justify the investment of large sums of money required for a modern oil refinery, pulp mill,

or aluminum works, unless one has reasonable assurance of a substantial proportion of his raw materials and of an outlet for his finished products. Integration saves much time, effort, and expense in buying and selling between divisions; gives the company an opportunity to plan ahead with some confidence; and minimizes fluctuations in earnings. The quality of products, from raw materials to finished items, can be carefully controlled. Also, an integrated company can make sounder decisions as to where new capital is most needed than a company which sees only one angle of the whole picture.

Provision of adequate transportation facilities, such as pipelines and tankers, can be planned more efficiently and intelligently if one is reasonably certain about where his supply is coming from and where his products are likely to be sold over the next decade or two. Ownership of raw materials and transportation facilities, moreover, makes it possible for a company to protect itself against unwarranted price increases and monopolistic action by suppliers. Such ownership also protects against possible plant shutdowns in the event of strikes or other unusual interruption of supply.

Perhaps the greatest advantage of integrated buying and selling lies in the control which centralized management exercises over the flow of products from primary plants to consumer outlets. Large companies find profit and economy in exercising the traditional activity of merchants for several reasons. First, in keeping supplies in their own hands until sold to fabricators or consumer outlets, they are able to avoid a substantial amount of the competition among merchants which traditionally operated at the distribution level. At the same time, in controlling a substantial flow of products, a central management is able to coordinate intracompany sales and purchases with a minimum of sales effort and handling cost. The flow of products is regularized, and extremes in local gluts and shortages are avoided.

Advantages in Meeting Capital Needs

Bigness in corporate size simplifies the problems of new financing for expansion, modernization, and the development of new products. A principal function of a multiplant firm is to provide its various plants with funds for working capital or plant expansion. Earnings from one branch may be used to help finance some other branch of the business. When large corporations need to borrow, they usually can do so with greater ease and on a low-cost basis.

Large corporate units also have an advantage in financing the development of new products or in improving old ones. In the automobile industry, for example, the cost of designing an engine from scratch, building prototypes, and giving these both laboratory and road tests, will be approximately the same whether the company intends to build three or three million cars of the final design. The larger automobile companies and the larger divisions of

those companies have an advantage in being able to spread such development costs over a larger number of cars.

Many investors favor the securities of large corporations. Such securities have a broad and ready market. They also make it possible for an investor to diversify his risk over the several lines of business usually conducted by a large enterprise.

Advantages in Diversification

Large company size makes possible the reduction of risk and the offsetting of losses through diversification. With the central ownership of numerous separate plants, a company is able to reduce the risk of cyclical fluctuations in various lines of business. The impact of seasonal variations likewise can be minimized by acquiring additional plants in other lines or in other areas of production. Effects of mistaken judgment or operating losses in one division can similarly be offset by the group ownership of separate plants. The introduction of new products, such as canned meats for babies, may require a company to incur a loss on operations for as many as three to five years.

The advantage of bigness in offsetting losses—fortuitous or planned—was emphasized by Mr. Crawford H. Greenewalt, President of E. I. du Pont de Nemours, in a Congressional hearing. The following questions were asked of Mr. Greenewalt:

CHAIRMAN: Is it not true that you have two or three departments, and you can compensate yourself for your losses in department A by your profits in departments B and C? Is that not correct?

MR. GREENEWALT: That is quite correct, sir.

CHAIRMAN: And, if an individual goes into business and he has one department, he has to sustain his entire losses and cannot get compensation for those losses in any of the other departments. That is the advantage—that is one of the advantages of bigness, is that not true?

MR. GREENEWALT: Indeed, yes.[5]

Big Business Essential for Defense

Large-scale business has advantages in serving the needs of defense. It can take big defense contracts and fill them in the shortest possible time. It also has the organizational ability and know-how for filling large orders. Defense agencies lack experience for the effective allocation of production assignments. The experience of World War II and the Korean War showed the advantage of giving contracts to large companies to subcontract and to administer. The coordinating skills of big business management are of vital importance in national defense.

[5] Hearings Before the Subcommittee of the Committee on the Judiciary, House of Representatives, 81st Congress, first session, Serial No. 14, Part 2A, 1950, p. 565.

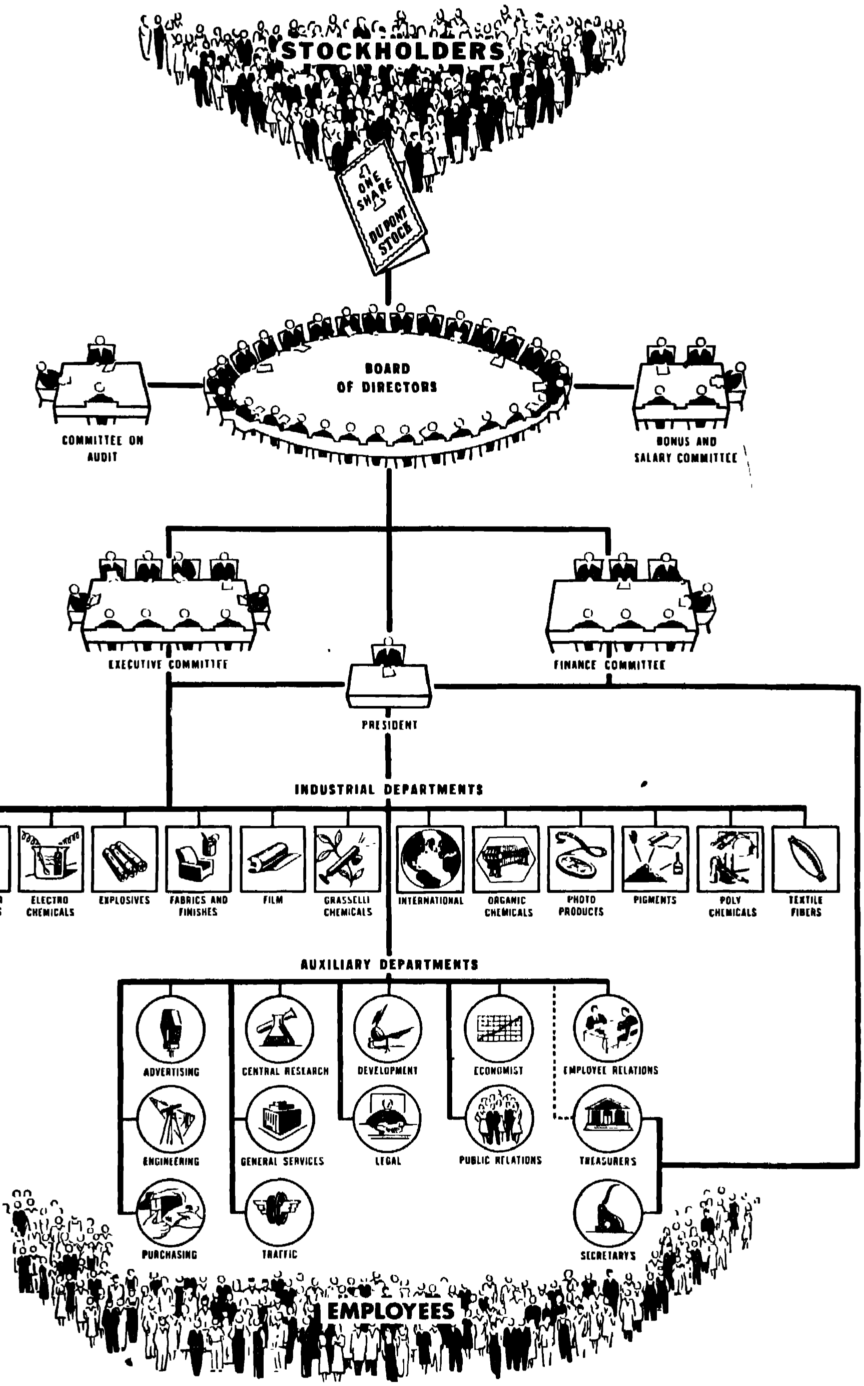


FIGURE 9. Organization Chart for a Large Business Corporation. (Courtesy of E. I. du Pont de Nemours)

Big business, moreover, has the skill to develop, implement, and coordinate large defense operations. The development of atomic energy during World War II was undertaken by such large companies as du Pont and General Electric which had large and varied organizations with diverse skills and great numbers of scientific specialists. Large organizations with staffs trained in time of peace stand ready to serve in emergencies. They cannot be hastily assembled for a defense need.

Big Business Actively Concerned with the Judicious and Beneficial Use of the Advantages of Size

The whole substance of the social justification for big business is that advantages inherent in the large corporation are *passed along to the consumer* as benefits in the form of lower prices, improved quality of products, new varieties of products, and superior service.

Many of the advantages of big business detailed in the foregoing sections are advantages enjoyed by the corporation itself. These advantages, however, do not end with the corporation. There is not a development of power for power's sake. Large business units must serve the consuming public. Their very existence and success depend upon it. In so doing, they reflect and express their advantages in better working conditions, higher wages and related benefits, better service, and improved products at lower prices. The nation, as a whole, gains as a result of the advantages which large companies have in many areas of business.

THE CASE *AGAINST* BIG BUSINESS

Critics of the vast movement toward concentrated control recognize that there undoubtedly are advantages in large-scale research facilities, topflight management, product diversification, and mass advertising. Large plant and corporate size, it is likewise seen, are needed in many industries to produce essential products with the latest technology. The focal point of criticism is that of financially large, multiplant corporations, possessing dominant power with trade-restraining effects.

According to critics of big business, giant company size is neither the result of modern technology nor is it inevitable. Available evidence points to the conclusion that extreme corporate concentration has been the result of (1) a drive for growth and increased profit revenue; (2) changes in our corporation laws which have made it possible for corporations to engage in more than one kind of business, to form subsidiaries, and to own and vote the stock of other corporations; and (3) the failure of the executive, legislative, and judicial branches of government to give vigorous support to the antitrust laws.

The main arguments which are made against very large business combinations are the following:

Large Business Size Often Gives Rise to Monopolistic Action, Forms of Which Are Not Now Reached by the Antitrust Laws

Large business units in various lines of business have secured a unified control over price in their respective fields. Monopolistic control is typically evidenced by (1) unity of action on price, i.e., the quoting of identical delivered prices; (2) "price leadership" in which a dominant seller makes the going price—in a given sales area or for a certain product—which is largely observed by others; (3) the widespread practice of refusal to sell in which small business firms are denied essential supplies; (4) the growth and prevalence of rigid, administered pricing in important basic industries; and (5) the practice of charging higher prices in localities where competition from small business is not active and lower prices (sometimes below cost) in areas where competition is a bothering factor.

In many situations, the monopolistic practices of large business firms are not currently condemned by the antitrust agencies and the courts. The law, as presently construed, looks mainly for *conspiracy* and *intent to injure;* and when these features cannot be proved, the courts accept many business practices which economic analysis identifies as monopolistic. Congressional committees, for example, are currently questioning the practices of identical bidding, refusal to sell, local price cutting, and administered prices, all of which are found to exist in spite of the law. In the opinion of some investigators, the monopolistic practices of large business firms can be curbed only by reducing business size, for they are the product of size itself, rather than of conspiracy or illegal intent.

The main problem of unified selling in the American economy is expressed in the "Big Threes," "Big Fours," and "Big Fives" which have come to dominate the various industrial fields. As a result of mergers and the building of additional plants, a few large concerns now produce the bulk of the output in many industries. No one concern enjoys a single monopoly control, but the very fewness of the dominant concerns makes possible concurrent action. It is this fact which gives rise to the view that whenever size threatens the principle of competition, it should be reduced by legal action.

Professor C. D. Edwards made a study of the extent to which some fifty of our largest companies have, in fact, violated the antitrust laws. Typically, big business is pictured as being "gentlemanly" in its conduct, with no admixture of evil. Professor Edwards found, however, that thirty-five of the largest fifty industrial companies have lost one or more cases in proceedings brought by the Department of Justice. Six others (in 1956) were defendants in pending cases, and only nine have not been involved in a case. "This analysis," concludes Professor Edwards, "supports the conclusion that violation of the central prohibitions of the antitrust laws is too common among

big companies to be disregarded or treated as an unimportant aspect of the conduct of these companies. Abuse of power for monopolistic purposes is a significant and recurrent pattern of big business."[6]

Allegations of Great Economies Unproved

There is no conclusive evidence to indicate that the unit costs of large companies are typically below those of small and medium-sized firms. In a study of costs in the steel industry, Professor George Stigler found that costs of the United States Steel Corporation ranged about in the middle of the costs of other steel firms.[7] Upon the basis of numerous cost studies in various industries, another authority reports: "As a generalization from the inadequate data available, it may be said that there is little evidence to support the conclusion that the largest enterprises are relatively inefficient. Nor, on the other hand, has it been proved that they have a superiority on a cost basis."[8]

After making a thorough study of available evidence on the relative efficiency of big and small business (as measured by money costs) Professor C. D. Edwards concludes "The claim that they [big business firms] tend to be more efficient than smaller concerns must be regarded as not proven."[9]

It is possible that multiple-plant ownership may bring economies in financing, research, lobbying, advertising, and selling, because expenditures for such activities can be shared jointly by the various plants under a central control. Large companies, on the other hand, are particularly vulnerable to public criticism, and much money must be spent in maintaining public relations departments, and in public relations activity. This is a cost burden which small and medium-sized companies do not need to incur. Beyond a certain point, moreover, large-scale operations bring a decrease in efficiency. Large buying of supplies creates problems of warehousing and aggravates the risks of change in price, style, and product composition.

In many cases sellers do not offer a lower price for buying more than one carload, so that the economies of large-scale buying are soon exhausted. Usually low buying prices secured by certain chain buyers frequently are discriminatory and stand condemned by the Robinson-Patman Act.

Increasing corporate size, it has been found, creates numerous managerial difficulties. The top management of a large concern cannot know all the details of the business and must rely upon the reports of subordinates. Such persons are frequently reluctant to prejudice their careers by taking risks or by trying uncertain methods. Company heads who make decisions are remote

[6] C. D. Edwards, *Big Business and the Policy of Competition* (Cleveland, 1956), p. 68.

[7] Statement of George J. Stigler, Committee on the Judiciary, House of Representatives, *Study of Monopoly Power: Steel*, Serial No. 14, Part 4A, 81st Congress, second session, 1950, p. 122.

[8] Richards C. Osborn, "Efficiency and Profitability in Relation to Size," *Harvard Business Review*, March, 1951, p. 92.

[9] Edwards, *op. cit.*, p. 95.

from those who execute them. Bureaucracy develops, and business becomes organized and operated, by rules and committees rather than by individual judgment.

Small business has the very real advantage of being able to establish effective teamwork with much less fuss and bother than big business. A small company enjoys the advantage of having its top management know details of current operations at first hand. Decisions can be reached quickly and effectively. Managerial efforts are linked more closely to results, and junior executives are given opportunity to secure all-round development. Many young men are often explicit in their preference for a small concern, citing as a reason a feeling that "you get lost in a big company."

In a number of fields, central buying has made it possible for independent retailers to secure buying prices comparable with those paid by large chains. At the same time, independents have advantages in management, in timing their activities, and in knowing their local communities.

Claims That Extremely Large Multiplant Corporations Are Necessary for Progressiveness in Research Unsubstantiated

Critics of corporate concentration point out that there is little evidence to indicate that economic concentration is a necessary condition for progressiveness in research and development. In aluminum, steel, and automobiles, for example, where a high degree of concentration exists, most of the innovations have come from outside of the industry or have been pioneered by smaller firms.[10]

Individuals and small business firms, it is claimed, are the source of many discoveries which are later developed and manufactured by large business concerns. Indeed, it is said, basic research and inventions are more likely to come from individual inventors than from corporate research.[11]

To the extent that large business size has an advantage in research and development, it lies primarily in having research laboratories and financial resources which make it possible to bring a discovery into actual production. Only a case-by-case study, however, can determine the financial size needed for the development of a new product.

In steel it is almost axiomatic that the small companies come forth with the greatest metallurgical and technological advancements. There is a logical reason why this is true. In high alloy steel, for instance, a new product almost always begins in a small way. It has to find its place in industry; therefore in the beginning it is a small-tonnage, small-profit item. Large steel companies are not set up to manufacture at a single time a few hundred pounds of steel of some new type. The smaller companies, which are able to tailor make their

[10] John Jewkes, David Sawers, and Richard Stillerman, *The Sources of Invention* (London, 1958), pp. 157, 168–182.

[11] T. K. Quinn, *Giant Business* (New York, 1953), pp. 113–116.

products, create new business for themselves by producing such new materials. Eventually when a particular alloy matures to the extent that it can be considered a tonnage product, the larger companies begin making it. The same thing is true of many processes for steel production. Smaller companies are usually better equipped to make technological changes than the larger organizations where facilities are standardized.

The National Steel Corporation, having some 5.3 percent of the industry's net capital assets and about 5 percent of the ingot capacity, has made many notable innovations in the steel industry. In 1926 it installed the first fully continuous, four-high rolling mill; in 1938 it pioneered the development of the electrolytic line for producing tin plate; and in 1950 it began construction on one of the largest oxygen plants in the United States. During Congressional hearings on bigness and technology in the steel industry, Mr. Ernest Weir, chairman of the National Steel Company, was asked, "Do you think your firm is too small to be able to effectively do research or to develop these new processes and methods?" Mr. Weir replied, "Not at all, no, sir."[12]

The history of some of our large corporations, with respect to technical progressiveness, stands in sharp contrast to that of smaller companies. In 1935, for example, the United States Steel Corporation employed Ford, Bacon and Davis, an industrial engineering firm, to survey the firm's productive efficiency. The results of this private study were publicly revealed in 1950 during the course of Senate hearings on monopoly power. Summarizing the findings at the hearings, Professor George W. Stocking stated that the engineering firm

> . . . pictured the Steel Corp. as a big sprawling inert giant, whose production operations were improperly coordinated; suffering from a lack of a long-run planning agency; relying on an antiquated system of cost accounting; with an inadequate knowledge of the costs or of the relative profitability of the many thousands of items it sold; with production and cost standards generally below those considered everyday practice in other industries; with inadequate knowledge of its domestic markets and no clear appreciation of its opportunities in foreign markets; with less efficient production facilities than its rivals had; slow in introducing new processes and new products.
>
> Specifically, according to the engineers, it was slow in introducing the continuous rolling mill; slow in getting into production of cold-rolled steel products; slow in recognizing the potentials of the wire business; slow to adopt the heat-treating process for the production of sheets; slow in getting into stainless steel products; slow in producing cold-rolled sheets; slow in tin-plate developments; slow in utilizing waste gases; slow in utilizing low-cost water transportation because of its consideration for the railroads; in short, slow to grasp the remarkable business opportunities that a dynamic

[12] Hearings Before the Subcommittee of the Committee on the Judiciary, House of Representatives, 81st Congress, second session, Serial No. 14, Part 4A, 1950, pp. 808–809, 835.

America offered it. The corporation was apparently a follower, not a leader, in industrial efficiency.[13]

Upon the basis of an extensive study of individual and corporation research, Professor John Jewkes and associates conclude that

1. The large research organizations of industrial corporations have not been responsible in the past fifty years for the greater part of the significant inventions.
2. These organizations continue to rely heavily upon other sources of original thinking.
3. The organizations may themselves be centers of resistance to change.[14]

Research Expenditures Concentrated in Few Firms. It may be noted in Figure 10 that a substantial portion of the money spent on research and development by corporations comes from the federal government. In aircraft,

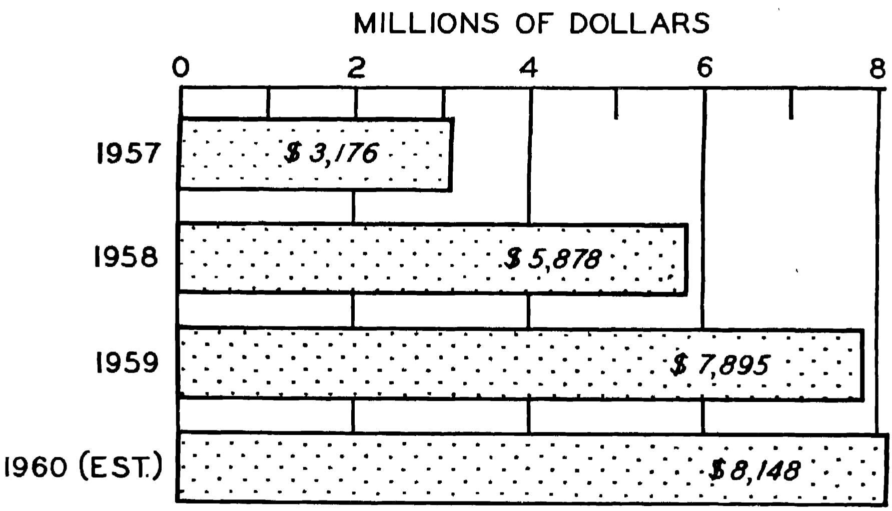


FIGURE 10. Federal Research and Development Obligations. The federal government finances about sixty (60) percent of the research and development performed by industry. In addition, the federal government finances and conducts research and development, itself, in its own laboratories. Note the accelerating trend of federal expenditures for research and development. (Source: *Federal Funds for Science*, National Science Foundation, 1959)

the federal government meets around 84 percent of corporation expenditures; in electrical equipment, 54 percent; in scientific instruments, 45 percent; and in telecommunications and broadcasting, 52 percent.[15]

[13] Hearings Before the Subcommittee of the Committee on the Judiciary, House of Representatives, 81st Congress, second session, Serial No. 14, Part 4A, 1950, pp. 966–967.

[14] Jewkes, *et al., op. cit.*, p. 185.

[15] National Science Foundation, *Science and Engineering in American Industry* (Washington, D.C., 1956), p. 17.

Upon studying expenditures for research, Professor John Jewkes and associates conclude: "The industries which conduct the greatest amount of research are those which get the largest government grants and those which get the largest government grants are those whose efforts are, or are supposed to be, most intimately bound up with national defense."[16]

Small businesses can rarely obtain government contracts for research and development because of the limited facilities and laboratories which they have. Large businesses thus have a very substantial advantage in being the main recipients of federal funds (see also Chapter 12, pages 285–286; and Chapter 16, pages 363–365).

The "outstanding fact" about research in industry, states the Paley Commission Report, is its concentration in a few industries. Four groups—chemicals, communications, petroleum (including coal products), and aircraft—in 1950 accounted for fully 50 percent of the total industrial research activity. The entire mining industry, by contrast, contributed less than one half of 1 percent.[17] As of 1958, Professor John Jewkes and associates reported that more than one half of the research and development expenditures in the United States were being incurred in the aircraft, electrical machinery, and chemical industries.[18]

In the relatively few industries in which research and development expenditures are largely made, there is a high concentration of output in large companies. Large companies in these areas are, therefore, important factors in research. But large companies in other segments of the economy do not spend vast sums on research. It appears that factors other than extremely large multiplant size are responsible for causing a given industry to spend substantial amounts on research.

Basic factors stimulating applied research are the needs of national defense and critical human problems, e.g., remedies for cancer, polio, heart disease, and geriatrics; critical shortages of raw materials; and the existence of burdensome surpluses, waste materials, and by-products. With these underlying conditions present, a further factor making for intense research activity is competition, that is, an incentive to hold one's place in the industry, to develop new products, and to find new uses, before a rival captures the field.[19] Research thrives on problems, not because of company size.

Where small and medium-sized companies (units producing up to 5 per-

[16] Jewkes *et al.*, *op. cit.*, p. 149.

[17] President's Materials Policy Commission, *Resources for Freedom* (Washington, D.C., 1952), Vol. 1, pp. 140–141.

[18] Jewkes, *et al.*, *op. cit.*, p. 152.

[19] The Attorney Generals' National Committee to Study the Antitrust Laws, for example, reports: "Generally speaking, economists support competition . . . because the goad of competition provides powerful and pervasive incentives for product development . . . monopoly power implies . . . relative freedom from pressure . . . to develop new products, or otherwise to innovate. . . . It is an unsafe power to lodge in private hands, making the monopolist a judge in his own case" (*Report* [Washington, D.C.], 1955, pp. 317–318).

cent of the total output) continue to be a significant factor in an industry, they actively support research and account for a steady stream of new methods and products. Indeed, in some fields it appears that medium-sized companies are much more likely to pioneer new processes and products than the big companies. Medium-sized companies, experience has shown, enjoy a certain freedom and flexibility of action in matters of research and engineering developments. By employing a few high-caliber technical men, by operating in a speciality field, and by developing one or two general lines of products, they can frequently overcome any advantage a large company may have, and can develop, expand, and prosper in relation to large business.

Dominant Business Size Which Restricts Competition Operates to Impede the Rate of Capital Investment

Economic studies have found that there are in the structure of our economy today strong impediments to capital investment—and hence, to employment and economic expansion. These impediments are seen to include monopolistic restrictions on entry, managed prices unrelated to market forces, and managed prices pegged at levels above those which would result from effective competition.

Professor Howard S. Ellis discusses the effect of monopoly on the rate of investment, as well as consumption, as follows:

> There are good reasons for believing that monopoly prices do actually restrict the flow of expenditures for both productive investment and consumption. . . . Consider first investment. In the particular equilibrium sense, monopoly consists essentially in investing less than the competitive limit. Capital—and with it also labor, managerial forces, and materials—is excluded from entry and thus tends to fall into the "unprotected" or open competitive segments. . . . On the other hand, resistance to downward revision of money rates—the "downward inflexibility" of interest, profit margins, and wage rates—results in system unemployment. Money which otherwise would have flowed into productive investment lies idle. . . .
>
> Monopoly prices inhibit consumption not merely of the high-priced monopoly goods, but generally. . . . These restrictive influences of monopoly are such as to exercise a continuous or "secular" drag upon employment. . . .
>
> Finally, in appraising the restrictive effect of monopoly upon investment and consumption, one should not overlook the fact that it would not always require an absolute rise of price or an absolute reduction of output for such restriction to be present. Suppose the introduction of economies in production to be attended by a process of monopolization. Then output may remain at the former competitive level and still signify a substantial restriction below what would be possible under competition.[20]

[20] Howard S. Ellis, "Monopoly and Unemployment," in *Prices, Wages, and Employment*, Board of Governors of the Federal Reserve System (Washington, D.C., 1946), pp. 70–72.

Professor William Fellner, upon making a detailed analysis of monopolistic restriction, states: "This analysis seems to point to the conclusion that, although the factors determining the degree of monopolistic restriction are not statistically measurable, an all-around tendency toward monopoly does lead to a restriction of aggregate output (income). Monopoly output is smaller than competitive output in each individual industry, and, therefore, also in the aggregate economy."[21]

Similarly, Professor Moses Abramovitz develops the view that "if competition can be made more free, the rate of investment is likely to increase . . ."[22] In the short run, reasons for this view are (1) the making of investments by new firms previously excluded from profitable markets, (2) the production of additional goods and services as result of more intense competition, and (3) the making of increased investments in producer's durable goods because of a reduction in their prices.

Over the longer period, Professor Abramovitz finds that with active competition and open markets, in place of monopolistic restrictions, it will be easier to bring new resources into use. There will be greater incentives to introduce more efficient machines and techniques and to bring new products to the consuming public. The entrance of new firms will also increase the demand for investment goods. Thus, with the destruction of monopoly controls, there will be a higher rate of new investment, both in the short and long run.

Large Company Size with Dominant Economic Power Results in Managed or Administered Prices

There is a consensus among economists that large company size gives one (or several companies acting in union) power to make the going price which is largely observed in the industry. This price is called a "managed" or "administered" price.

Dr. C. D. Edwards states the problem as follows: "There is general agreement that where a few big companies produce most of an industry's product, short-run price competition seldom exists. Change in quoted prices is infrequent. Large concerns usually set prices by administrative decisions made infrequently, and are reluctant to adjust prices to take account of day-to-day fluctuations in the market."[23]

As chairman for a special Senate committee to study administered prices, Senator Estes Kefauver prefaced committee hearings with the following statement: "The facts are that we do have on a widespread scale both the giant corporation and administered prices. The reality is that within a

[21] William Fellner, *Monetary Policies and Full Employment* (Berkeley, Calif., 1946), p. 87.

[22] Moses Abramovitz, "Savings and Investment," *American Economic Review, Supplement,* June, 1942, pp. 81–86.

[23] Edwards, *op. cit.*, pp. 77–78.

broad area of the economy prices are set, not automatically by the unseen hand of competition, as are prices of wheat and hogs, but by the conscious and deliberate action of corporation managers who have the power to set prices at alternate levels."[24]

Managed or administered prices, as found in concentrated industries, usually have the following characteristics: (1) identity of delivered prices (resulting from the use of a basing-point, zone, or freight-equalization system); (2) identity of price increases on the part of the producers; (3) the adjustment of prices upward during a period of full or near full capacity; and (4) the maintenance of prices at rigid or inflexible levels, without regard to changes in market forces. Monopoly prices may be flexible or rigid, and not all rigid prices are monopolistic. In general, however, rigid prices, as presently existing, are pretty closely correlated with monopoly.

A striking feature about administered prices in our concentrated industries is the fact that they are largely immune from antitrust prosecution. Under the Sherman Act, the Antitrust Division will take action only if price management and price identity flow from agreement (conspiracy) or from single-firm monopoly control of an industry. The Federal Trade Commission similarly limits its action. The main problem of unified selling, however, is one of *concurrent* action by several large sellers, allegedly without agreement. The antitrust agencies observe identical pricing in many industries—such as steel and typewriters—but their investigations have not so far developed proof of conspiracy.[25]

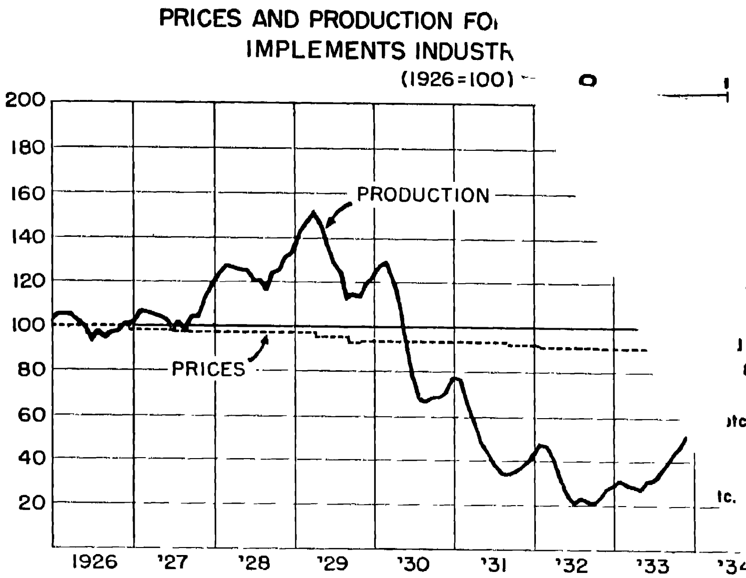
These are the economic effects of administered prices:

1. Buyers are denied the benefits of price competition. Administered prices are criticized by economists because they are typically *identical*, quoted according to a basing-point or zone formula. When prices quoted are identical, the purchaser is denied any price advantage which would result from genuine competitive bidding. He is, in effect, given one bid and one price. Competitive bidding has long been regarded as sound public policy designed to provide the buyer with a price advantage arising in the more favorable market position of some supplier; or from lower costs, more efficient methods, lower profit markups, or a more urgent need for sales.

2. With managed prices, a decline in demand usually results in a decrease in production rather than in price. Administered prices are criticized for the role which they play in aggravating and prolonging business recessions. As long as the volume of sales is expanding, as it typically is during a period of prosperity, the influence of monopolistic restrictions on the level

[24] *Administered Prices—Steel*, Report of Proceedings, Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, Vol. 1, August 5, 1958, p. 2.

[25] The only exception to repeated attempts of the antitrust agencies to secure evidence of price fixing in the steel industry, it is reported, is that of the Allegheny Ludlum case (1945), in which eighteen corporations entered into a consent judgment enjoining them from fixing prices and arranging identical bids on government contracts. See *Administered Prices—Steel, op. cit.*, p. 25.



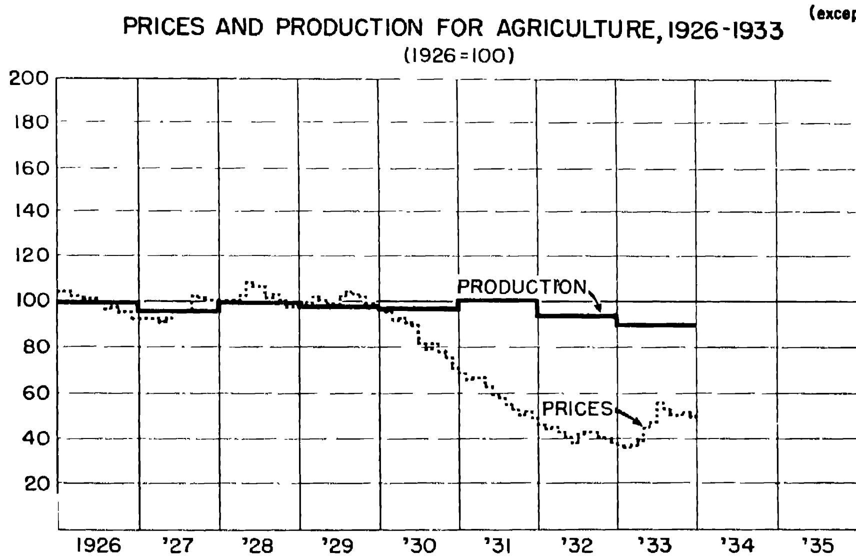


FIGURE 11. Rigid Versus Flexible Prices in a Depression Period. Rigid prices are closely correlated with fewness of sellers and managed prices (basing-point and zone pricing systems, industry-wide wage contracts, and public utility rates). Competitive industries reduce prices to find selling outlets. Oligopolistic industries, on the other hand, peg prices in the face of declining demand in their attempts to maximize profits. Industries able to peg their prices during a depression gain at the expense of the rest of the community. (Source: United States Department of Agriculture)

of employment is not immediately felt. New facilities may not be expanded to any great extent in various monopoly fields, but labor and materials are in general demand for other uses.

It is when depression strikes that monopolistic restrictions tend to promote a condition of chronic or persistent unemployment (see Figure 11). Since consumer the fc reduced incomes, they can buy in volume only at low prices. Industri rom the le groups having monopoly power, however, find that their maxin ntity of prifts are obtained by raising prices or by holding prices up. This of prices as to keep excess capacity unused.

The mainl Trade Commission has said of the maintenance of high and in changes rices in the steel industry: "The ability to decide on a price and all n regardless of demand, which is the essence of monopoly, is a prime factor in establishing the vicious circle of high prices, restricted production, and reduced employment so widely condemned as 'scarcity economics.'" And further: "High prices, not in conformity with the law of supply and demand, place unreasonable limitations on use of the material. The effect, when combined with that of similar artificial prices in many other lines of production, is a depressed condition which can be kept from utter collapse only by repeated doses of public subsidy."[26]

3. Administered prices, reflecting private discretionary control over price, tend to be increased substantially when the economy is at or near full capacity and employment. In concentrated industries, where there is discretionary control over price, recent studies show there is a tendency for price managers to make substantial price increases during a period of high employment. Such increases may be promoted by (1) cost-push factors (rising costs, particularly labor costs); (2) the growing costs of nonprice competition (such as advertising, the making of model changes, and the supplying of equipment to customers); and (3) the desire of management to make a certain target return (percentage return on investment) regardless of the level of operations. In industries in which private discretion over price does not exist—as in agriculture—such price inflation does not arise.[27]

Dr. Gardiner C. Means has presented evidence showing that the increase in the level of prices through October, 1958, as compared with 1953, was mainly the result of administrative action, not high demand. This is called "administrative" inflation in contrast to "demand" inflation (see Figure 12). According to Dr. Means, the price rises in the inflation from 1953 to October, 1958, occurred primarily in the industry groups dominated by administered prices. In the competitive groups of food, leather, lumber, textiles, and farm products, prices rose very little or actually declined.[28]

[26] *The Basing Point Problem*, Monograph 42, Temporary National Economic Committee, 76th Congress, third session, 1941, pp. 4, 5.

[27] John M. Blair, "Administered Prices," *American Economic Review, Papers and Proceedings*, May, 1959, pp. 431–450.

[28] *Administered Prices*, Hearings Before the Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 86th Congress, first session, 1959, Part 10, pp. 4897–4902.

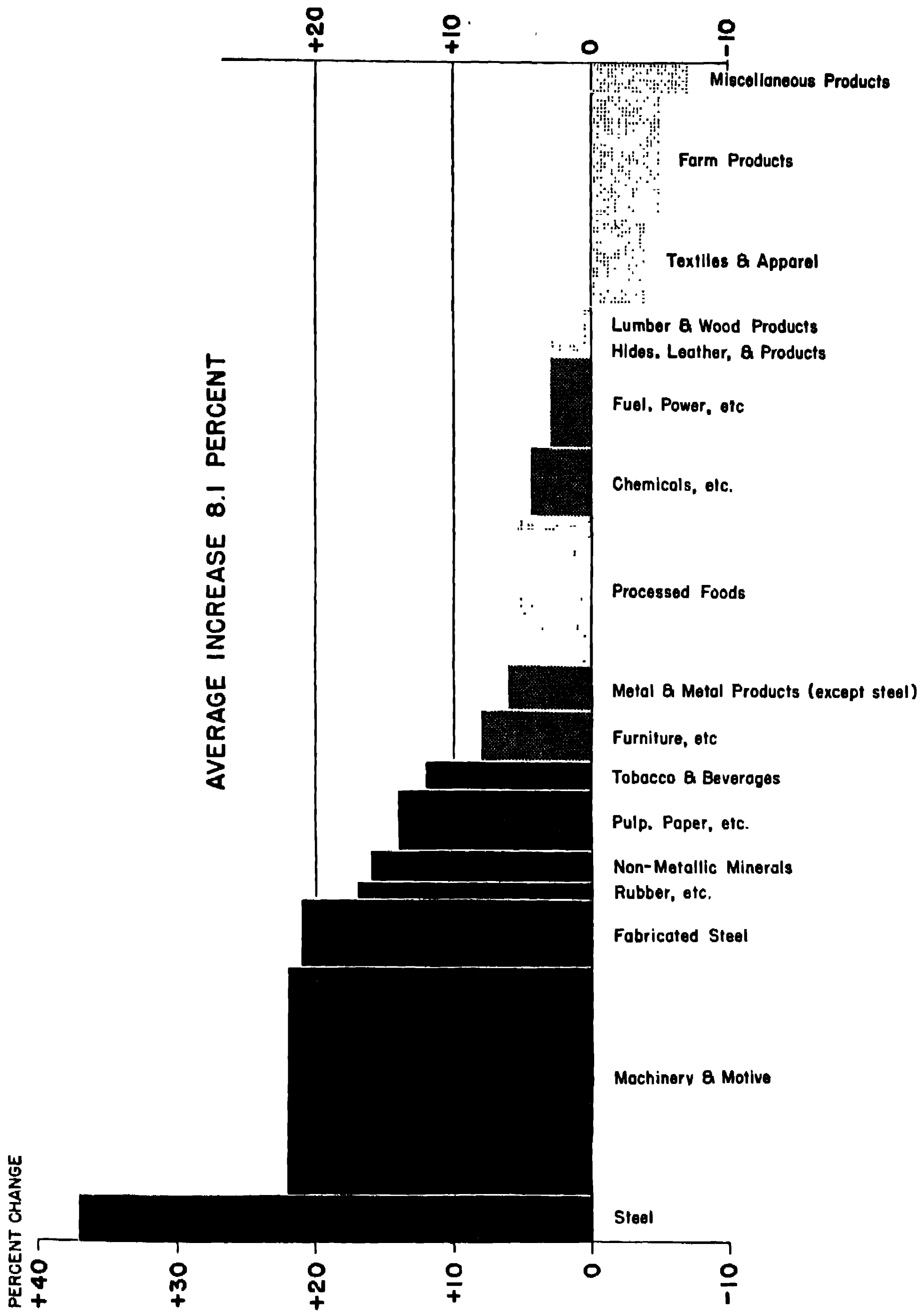


FIGURE 12. Wholesale Price Changes by Product Groups, October, 1953, to October, 1958. The period was one of moderate utilization of capacity. The inflation shown, it is reasoned, was not the result of excess demand but rather of price administration. (Source: *Administered Prices*, Committee on the Judiciary, 86th Congress, first session, 1959, Part 9, p. 4754)

When business management has discretionary power over price (as it typically has in concentrated industries), there is the opportunity to push up prices, with or without high-level demand. Whenever wages are raised, there is a strong incentive to use this power and raise prices to cover cost increases. Business managements may also use their discretionary power to raise prices in order to secure funds for plant expansion and modernization and, generally, to increase profit returns.

A problem of great importance in the American economy is how to restrain the price inflation which has been occurring in the concentrated segment of the economy since 1953. Inflation is usually defined as a situation in which there is extensive *excess demand* for available goods and services (at noninflationary prices). A number of economists believe that monetary-fiscal measures to reduce aggregate demand are not useful or practical, because they can be a remedy only by sharply curtailing output and employment. The price inflation which develops in the concentrated industries is a *special* problem, growing out of private discretionary control over price. Professor Galbraith and others believe that this kind of inflation calls for some type of direct price and wage control (see also Chapter 23, pages 511–513).

Big Business Has Great Financial Power and May Advance Its Position by Sheer Bigness

Large corporations, critics declare, have an advantage in sheer financial bigness. Their great financial resources can be used in manifold ways to outbid and outspend smaller rivals. This financial power may be employed to acquire the best sources of raw materials; to conduct prolonged patent litigation; to blanket the market with vast advertising campaigns; to take low markups on products in which small business is actively competitive; to build up their distribution of products with gifts, gratuities, loans, and so forth, to dealers; and to maintain effective political contacts in the national and state capitols.

An example of the alleged use of large financial resources to restrain competition is found in a complaint issued by the Federal Trade Commission in 1958 against the Shell Oil Company (Docket 7044). In this complaint the Commission charged that Shell attempted to induce automobile dealers to use its oils and greases by supplying them with lubricating equipment, making gifts of cash, advancing money for alterations, paving driveways, painting buildings, and otherwise meeting various capital needs.

In developing the case, the legal staff of the Commission maintained that this "capital investment competition" is of such a great magnitude that it is destroying existing competitors and preventing the entrance of new ones. Small concerns, it was emphasized, do not have financial resources to carry on such practices.

Similarly in a series of related complaints (Dockets 6172–6179, 6425), "the

dairy cases," the Commission charged that nine large ice cream companies caused a substantial number of small manufacturers to go out of business by their practices of "buying" customers instead of competing for them. These practices consist of making loans of money and gifts of cash, financing the purchase of equipment, supplying ice cream cabinets free of charge, providing signs and equipment used in selling other products, and making special price concessions.

In initial decisions hearing examiners for the Federal Trade Commission dismissed the complaints in the Shell Oil and Dairy cases. Their view was that the alleged practices were not used in an "aggressive" or "excessive" way to bring "substantial" injury.[29] These cases were the first to question the use of large financial resources to restrain competition by the buying of distribution with gifts, gratuities, loans, and favors. The Federal Trade Commission has announced that it will review the initial decisions.

PUBLIC POLICY AND BIG BUSINESS

At present, conservatives and liberals alike are giving increasing attention to the policies which government should adopt with respect to large corporations and unified pricing methods. The attitudes developed by various groups are highly important, for in our American democracy public opinion is basically responsible for the actions taken by the President and Congress.

The principal alternatives in public policy will be studied in subsequent chapters. In summary form, however, the main policies which might be adopted are as follows:

1. The acceptance of the status quo and the abandonment of the competitive standard expressed in the antitrust laws. Persons holding this view declare that the "ceaseless striving" among the giants for business, the competition in advertising and salesmanship, and the competition of substitutes make for a workable kind of competition. "Effective competition," it is said, means (1) "freedom of choice of goods and services" and (2) "the opportunity for others to engage in such competition" even though there is no independent rivalry among sellers on price. Effective competition (in the foregoing sense), they believe, makes for "the creation of new and better products and new and cheaper methods." Buyers enjoy "alternatives among goods and services as well as among sellers."[30]

Persons embracing the so-called "new" concept of competition usually state that *formal* conspiracies on price and predatory competition should be condemned. In their view, however, nothing should be done to modify

[29] *Initial Decision,* Docket 7044, Federal Trade Commission, January 26, 1959; and *Initial Decision,* Dockets 6172–6179, 6425, June 26, 1959.

[30] See *Effective Competition,* Report to Secretary of Commerce Charles Sawyer by his Business Advisory Council (Washington, 1952), p. 9.

oligopoly or prevent the continuing growth of large business size by mergers and the formation of subsidiaries. Application of the antitrust laws against the "Big Threes" and "Big Fours," it is declared, would strike at the very basis of our business prosperity, defense strength, and economic well-being. No action, it is added, should be taken against "administered prices" which exist in important sectors of the economy. Identical delivered pricing and price matching, indeed, are considered to be aspects of a normal competitive economy.

The proponents of the "new" competition—the idea that substitute products provide effective competition—urge that business be judged by economic performance, not by the straight jacket of the antitrust laws.

2. Extension of some sort of public price control to the concentrated industries as a supplement to present-day antitrust policy. A distinctive feature of industries having a high degree of economic concentration is, we have seen, the setting of prices by centralized management rather than by the free operation of the forces of supply and demand. Experience has shown that the central managements of oligopolistic industries act to pass wage adjustments along to the public by deliberately raising their administered prices. They act also to mark prices upwards even in the face of declining demand. In these and other situations, Congress, small business, and consumers generally, ask if such increases are really warranted.

In an effort to temper private price control by large business concerns, it has been proposed that price leaders in the administered price industries give advance notice of planned increases. This would permit public discussion and protest.[31] Senator Joseph C. O'Mahoney in 1958 introduced legislation to require "dominant corporations" in various "heavily concentrated" areas to give the government thirty days advance notice of any planned price increase. The Attorney General and the Federal Trade Commission would be empowered to require the company to produce accounting data and reasons for the proposed increase. After thirty days and the spotlight of publicity, the company would be permitted to raise its prices.

The essential weakness of the proposals to control oligopolistic prices by the technique of advance notice and public discussion is the absence of coercive power to deny increases which powerful economic groups are determined to secure. Pressures on Congress to prevent "unwarranted increases" may lead to further proposals calling for public price fixing by a government commission. Such a commission would be given power to approve or disapprove the proposed prices or to prescribe actual prices—as in the case of public utilities.

The opinion of some economists is that an extension of public price control to cover the products of oligopoly would impose insuperable burdens on public agencies. One reason for this view is the difficulty involved in

[31] See, for example, the testimony of Professor John K. Galbraith in *Administered Prices*, Hearings Before the Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 85th Congress, first session, 1957, p. 50.

estimating and distributing fair overhead costs and fair rates of return over the wide range and variety of products produced by the dominant industrial enterprises. Another reason is the probability that increased price fixing by government will lead to still greater lobbying and political activity by the major interest groups. It may be necessary in certain areas for the public to protect itself with price fixing by public commissions. In other fields of business, however, the more practical and promising remedy for monopolistic control, it is believed, is that of a strengthening and invigorating of the enforcement of the antitrust laws.

3. A third principal type of policy which may be employed with respect to large business size which demonstrates anticompetitive effects is that of (1) making illegal all trade-restraining practices and discriminations which injure competition, regardless of conspiracy, illegal intent, or other defense (Chapter 8, pages 166–168; Chapter 14, pages 319–320; Chapter 15, pages 346–350); (2) checking the further growth of large corporations by means of merger (Chapter 14, pages 325–327); and (3) moving in the direction of reducing large business size in areas in which anticompetitive behavior persists (Chapter 9, pages 198–205).

A plan of reducing large corporate size by creating a number of independent companies does not mean that industry would be "fractionalized," "pulverized," or "atomized," as the critics of antitrust declare. The key problem of bigness is *supercorporations*—i.e., those which have "dominating power" with "anticompetitive effects."[32] As Dr. Edwin G. Nourse has stated, "We can't hope to get back to small-scale competition. But in my judgment, there is such a thing, for an economically sophisticated people, as genuine large-unit competition. And that is what we are trying to accomplish, not have them so large and so sprawling as to abuse that power, but to use it intelligently."[33]

In the main, public distrust and opposition to large business size reflects the distrust of power which threatens the principle of competition. The American people want a choice of suppliers and customers; they want active competition on price, in buying and in selling. Whenever in a given market situation large business size threatens the principle of competition or has anticompetitive effects, the supporters of competition declare, this size should be scrutinized and reduced by legal action.

The basic purpose of a business corporation is to make profits and grow with an expanding economy. But, in fact, the directors of a corporation have an interest in a larger problem than growth and size—namely, the preservation of a free, competitive economy. The alternative to a system of competitive markets, economists have long emphasized, is a regime of monopolistic selling and eventually some form of public price control. When effective com-

[32] See also the testimony of C. D. Edwards, *Administered Prices*, Hearings Before the Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, United States Senate, 86th Congress, first session, Part 9, 1959, p. 4820.

[33] *Ibid.*, p. 4731.

petition is weakened, the demands for public control and ownership rise loudly.

In the following chapter we shall study private monopoly, oligopoly, and unified selling. Following that chapter we shall consider in additional chapters the efforts of government to prevent and eradicate monopolistic power; and, when this has been found to be ineffective in particular industries, to adopt public price fixing and in some instances public ownership.

7

Monopoly, Oligopoly, and Welfare

The purpose of the present chapter is to analyze the nature of monopoly and oligopoly and to present a standard for appraising these situations as they exist in our commercial economy. It is the economic conditions of monopoly and oligopoly which give rise to the principal problems confronting government in the business field.

TENDENCY TOWARD MONOPOLY IN A COMMERCIAL SOCIETY

Historical studies indicate that monopoly, in the main, arises out of human action and human volition, rather than from impersonal, technological forces. Business enterprisers like to sell without competition, for it enables them to increase their incomes. With monopoly power, a single seller or a group of sellers acting as one is in a position to raise prices to the valuations of the most urgent buyers by curbing production or by withholding a part of the supply. Monopolistic buying, on the other hand, makes it possible for a group of buyers acting in unison to force prices down to the least that sellers will take, without fear of losing the goods to a higher bidder. The very real private advantages of monopoly in buying and selling led Josiah Tucker, an English economist of the eighteenth century, to declare: "All men, whether natives or foreigners, would be monopolists if they could."[1]

In his famous study, *The Wealth of Nations* (1776), Adam Smith reported: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[2] At the present time, close observers of the behavior of businessmen find that the same situation prevails today. Thus, the editor of a leading trade journal reports that two of the most fre-

[1] Josiah Tucker, *A Letter to a Friend Concerning Naturalization* (London, 1753), p. 24.

[2] Adam Smith, *The Wealth of Nations*, Vol. 1, Book 1, p. 130.

quently discussed subjects at the many trade association meetings which he has attended are (1) "price fixing" and (2) how "to keep competition out or new competitors from starting."[3]

NATURE OF PRIVATE MONOPOLY

Monopoly means unity of action on price in the sale of a commodity for which there is no close substitute. This unity may be exercised by a single person or by a group of persons acting as one. The purpose of having unified selling is to insure that there will be no price competition in the monopoly action of *raising* prices above the level which would exist under conditions of price competition. The source of private monopoly power—the power to raise prices above the competitive level—arises in the ownership or control of all or a large part of the supply of a distinctive class of goods. By controlling supply a monopolist is able to increase the prices received by (1) restricting the amount of goods offered for sale and (2) charging various groups of customers different prices on the basis of "what the traffic will bear." In restricting or curbing supply to secure higher prices, a monopolist adds a measure of *artificial* scarcity to whatever scarcity exists from other sources.[4]

From an economic point of view, the essence of monopoly is the power to manage price to make more profit by selling less. When there is no rivalry on price, there is monopoly even though a dozen salesmen are "competing" in the field for orders. Many businessmen and their legal counsel fail to understand the nature of monopoly. The Department of Justice, for example, reports the story of a corporation president who affirmed his innocence of monopolistic action by declaring: "I want you to know that our company does not want to monopolize this industry. We have intentionally kept prices high enough to permit our principal competitor to exist"!

The term "monopoly" is sometimes defined as a control over supply exercised by *one seller*. When there are two sellers of a homogeneous product, the condition is called duopoly; and when there are a few sellers—but not many—the case is one of oligopoly. Duopoly and oligopoly usually involve a condition in which a dominant seller, acting as a price leader, establishes or makes the going price which is largely observed in the industry. Since the several sellers act as one—usually according to a formula—duopoly and oligopoly are also described as cases of "multiple-seller" monopoly or

[3] W. A. Cyr, "What an Association Can't Do—And What It Can," *Electrical West*, April, 1948, pp. 65–68. See also *Trade Association Survey*, Monograph No. 18, Temporary National Economic Committee, 76th Congress, third session, 1941, pp. 71–103.

[4] Many persons minimize the significance of monopoly by declaring that the added cost is so little. This, in principle, was the thought of Rip Van Winkle who justified his drinking by not counting the little nips. When added up, however, the "little more" makes for large total amounts.

simply as "monopoly." In our present study, we shall use the term "monopoly" to include situations usually characterized as oligopolistic (see also Glossary of Terms at end of this chapter and Figure 19, facing page 169).

MONOPOLY AS A LOCAL AND LIMITED POWER

Since the sale of goods is always conducted at a place, private monopoly power comes into being as a local power—relative to a place. This means that the sales territory in which private monopoly power is exercised in the first instance is a regional area or zone. A cement mill, for example, rarely ships its product beyond a distance of 500 miles. Within a sales territory of this radius, buyers may have the choice of only one seller, or of several in collusion; and such a seller may charge a series of prices shading downward to the prices which he finds at the boundary line of his sales area. The exercise of local monopoly is thus limited by the presence of another seller located at a distance. In Figure 13, for example, it is assumed that there is unified selling at A and at B—one seller or several sellers acting as one at each point of production. The alternative source of supply for buyers at A (or B) is at the competitive market at C. Monopoly action at A (or B), therefore, can raise the price of a product at A to $38 per unit (the price at C plus $8 freight). At *d* mill A can quote a price of $37 and secure a net price of $36 ($37 less the actual freight); and at *g* mill A will quote $34 and secure a mill net price of $30. The exercise of local monopoly power in this example, it may be noted, shades off from a maximum at the mill at A to zero at the boundary line of its natural sales territory.

The monopoly power exercised by a locally separate mill (or several mills acting as one), it may be observed, is relative to space and limited by distance. Since the charging of local monopoly prices may bring a new mill into operation (the prospect of potential competition), private monopoly power may also be limited in time. The power to raise prices is further limited by the action of buyers in turning to goods of different quality or kind, i.e., *substitute* competition.

It is said that "appetite grows with eating," and the taste of monopoly profits may induce the enterpriser at A to acquire the mill or mills at B by merger. In this way the price leader can extend the size of the sales territory in which his monopoly power can be exercised. Private monopoly thus grows like a snowball. One advantage gained by the price leader at A (a private advantage and not a public one) in acquiring the mills at B is that with monopoly profits in the areas of A and B delivered prices can be cut on sales in the area of C, in a discriminatory way, to meet competition there.[5] By cutting his prices in the area of C—while maintaining them elsewhere—

[5] The terms "price cut" and "price cutting" may mean a uniform reduction in mill prices, but usually they mean a reduction of the mill price in one area while maintaining it on sales made elsewhere.

the price leader can keep the mills at C from expanding and becoming stronger competitors. This sort of competition is a *limited* kind of competition—that is, limited to those places where there are rivals. The other customers of the dominant seller are required to pay monopoly prices. Discriminatory pricing of this type is not the uniform, aboveboard sort of price competition found in open markets.

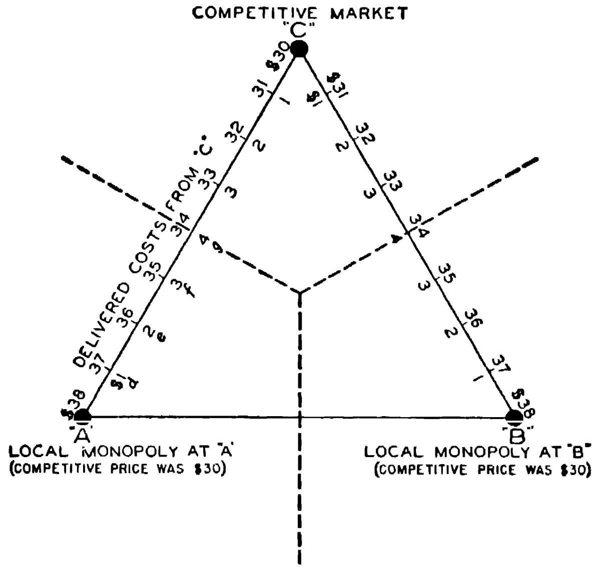


FIGURE 13. The Exercise of Local Monopoly Power. In the figure it is assumed that monopolistic control over price is exercised at A and at B. The alternative source of supply for customers in the natural sales territories of A and B is at C. Unified selling at A and B can result in prices being raised in their local areas to the level of prices at C ($30) plus freight from C. The delivered prices quoted by A, for example, will yield mill net prices varying from $38 at A to $30 at C. Divergent or variable mill net prices are an example of local or geographic price discrimination.

A price leader may also cut prices on sales in the area of C in a discriminatory way expressly to injure or destroy the mills operating in C. This is known as "cutthroat" competition.[6] As an alternative, however, he may just threaten to engage in cutthroat competition and by this means induce the mills at C to join hands in a policy of following the leader on price. The resulting unity may involve either agreement or concurrent action on the

[6] "Cutthroat" competition may be defined as the reduction of price in a discriminatory way in one sales area while maintaining it elsewhere, expressly to injure an independent seller.

part of the mills at C, based upon the prospect of added profits or the fear of cutthroat competition.

The foregoing example of unified action on price—based on price leadership and price following—is an illustration of the fact that it is not necessary for a single seller to control *all* of the supply in order to exercise monopoly power. Monopoly begins as a local power; and as a locally separate mill extends its area of control and influence, it may be able to establish or make the going price, or prices, which as an actual fact will be largely observed in a given sales area.

WAYS OF ATTAINING PRIVATE MONOPOLY POWER

Unified Selling May Be Effected by Concerted *Action (Collusion, Agreement) Among Competitors*

Monopoly power is frequently exercised by rival sellers operating in one or more sales territories by agreeing one with another that no one will sell for less than a certain price—or pay more than a certain price, in the case of a buyers' monopoly. Such agreements or understandings have long been known as gentlemen's agreements, since their observance is based upon the word or pledge of each seller. Collusion is most effectively secured and maintained when the number of sellers is small. In price-fixing arrangements the problem is *the other fellow's price.* If there are only two sellers, there is only one price to worry about and one other seller to convince; and if there are three sellers, only two individuals have to be kept in line. In some cases, agreements on price have been strengthened by written compacts, as well as by the deposit of sums of money to be forfeited by any member who breaks the agreement. Since direct evidence of agreement in such cases is easy to prove, monopoly leaders nowadays typically use more subtle methods of collusion. These include collective activity in trade associations; the use of basing-point and zone-delivered pricing systems; common affiliations with the same legal, banking, or accounting firms; interlocking directorates; and intangible personal ties of various sorts.

In several European countries where collusion is tolerated or accepted by government, businessmen openly engage in collective action on price and production. An association of independent firms in the same line of business for the purpose of agreeing on price and controlling supply is called a *cartel.* The word "cartel" comes from the Latin word *charta*, meaning a sheet of paper. Its application to price-fixing associations is to be found in the fact that agreements on price are frequently strengthened by means of a written covenant.

In the United States, collective action on price has long been held to be illegal, per se, and price-fixing activity is not openly discussed or admitted. As a consequence, the term "cartel" has not been widely used in this country. Mergers, on the other hand, have been looked upon with favor by the

courts, and business leaders have turned to the acquisition of competitors as the principal means of securing monopoly control.

It may be added that, since collusion or conspiracy on price is illegal under the antitrust laws, businessmen closely guard any agreements on price which they may make. Price understandings are usually reached in secret meetings and implemented by telephone conversations. In some instances, business executives instruct their secretaries in filing letters to destroy any which might reveal evidence of an agreement to a government investigator. In other cases, letters to be destroyed are expressly marked: "Please note this memorandum and destroy."[7] In consequence, direct evidence of an agreement on price is usually exceedingly difficult to secure.

Unified Selling May Be Effected by Concurrent *Action*

Monopoly, we have said, is defined as "unified action with regard to prices." This unity of action may be secured by *concerted* action (agreement, conspiracy) or by *concurrent* action (without agreement).

Economic and legal studies show that when sellers are few and when these sellers employ a certain rationale and mechanism, it is possible for unified selling to exist without agreement. *Concurrent* action, the evidence indicates, is grounded on three basic factors:

1. There is the use of some *system* or *method* of behavior by which uniform prices can be calculated. This may consist of a basing-point, zone, or freight-equalization system, or of the outright quotation of another's mill price, with actual freight payable by the buyer (see below, pages 134–137).
2. There is the *action* of each seller in making bids according to the system, knowing that others are doing the same, and knowing also that the natural and foreseeable consequences of this action will be matched bids.
3. There is the *knowledge beforehand*, or at least the expectation, that all sellers will follow the given system or method of pricing, so that agreement is not needed to use the system or to get the results of identical bids.

When a given method of pricing is concurrently used by industry members with the knowledge beforehand that others are doing likewise, matched bids arise automatically as a natural result. These three basics of identical bidding are the underlying explanation of "administered" prices, as well as of price leadership and price following—when they prevail in the absence of agreement.[8]

[7] *In the matter of Rigid Steel Conduit et al.*, Before the Federal Trade Commission, Docket No. 4452, *Brief in Support of the Complaint*, September 30, 1942; and *The Cement Institute et al.* v. *Federal Trade Commission, Brief for Respondent*, in the United States Court of Appeals for the Seventh Circuit, 1946, pp. 36–38.

[8] In the Conduit case (1948), the legal staff of the Federal Trade Commission developed this rationale, which explains identical bids not based upon collusion (agreement) (see Chapter 15, pages 344–346).

In a true competitive market, sellers act independently in quoting their own shipping-point prices. Each is trying to secure the business of a third party by offering the most favorable terms. No competitor knows, for sure, what the others are doing; and no one knows beforehand what all of his competitors will do. With *concurrent* pricing, these basic conditions do not exist. Sellers employ a mutuality of behavior which gives them the same results as collusive action.

Monopoly Power May Be Exercised and Increased by Cutthroat Competition

During the early period in the United States (1870–1903), cutthroat competition was a widely used device for eliminating rival sellers in a drive to expand private monopoly power. With local monopoly in one sales territory, multiple-plant companies slashed prices in another territory in which rivals were operating to drive them out of business. In a review of the methods employed by the large companies in oil, sugar, salt, copper, lead, tobacco, iron, and steel, to expand their monopoly position, the United States Industrial Commission in 1900 reported that the combinations "cut prices to an unreasonable extent in certain localities, and even to individuals at certain times, for the sake of driving out their rivals."[9]

The unfavorable attitude of the courts toward the use of cutthroat competition caused monopoly leaders in time to adopt a policy of "live and let live" with respect to the remaining independents. The United States Steel Corporation formed in 1901, in particular, pioneered this practice. In accordance with this new policy, if independents follow the leader on price and "cooperate faithfully," they are permitted to stay in the field. However, if the independents become recalcitrant and show a price independence, prices may be cut in a discriminatory way for *disciplinary* purposes. The modern monopoly policy is thus said to be one of inclusion rather than exclusion.

Mergers of Formerly Independent and Competing Plants as a Method of Restricting Competition

The most effective way of restricting price competition which monopoly leaders in the United States have hit upon is the method of corporate merger or combination (see also Glossary of Terms, page 94). This method came to be widely used soon after 1894. The acquisition of competitors may include those in processing and fabricating lines, as well as those owning supplies of natural resources and engaged in firsthand production. When formerly independent plants are owned and controlled, the management of the

[9] Report of the Industrial Commission, *Review of Evidence* (Washington, 1900), Vol. 1, Part 1, p. 20.

separate plants is rendered completely subservient on all matters pertaining to production, output, and prices. In the formation of the United States Steel Corporation, for example, Mr. Charles Schwab declared on this point: "That is the idea in our being the holders of this stock, in order that we may elect officers and directors who will be in sympathy with our policy."[10]

It may be noted that a merger of formerly competing plants in a particular section of the country which actually accounts for less than 5 percent of the sales in a given field in the entire country *may give the merger a control over all or a large part of the productive capacity in its area of practical shipment.* There is always an area of practical shipment for a mill or group of local mills, based upon f.o.b. mill prices and actual delivery charges; and in considering the monopoly power secured by a particular merger, one must examine the percentage of production or sales which it controls in its natural sales area.

"MONOPOLY IS WHAT MONOPOLY DOES"

There is a considerable literature on the economic effects of private monopoly power. Monopoly, it has been pointed out, promotes artificial scarcity and economic stagnation, aggravates and prolongs depressions, makes for an inequitable distribution of income, is sluggish and resistant to new methods, and is hostile to economic and political freedom.[11] These consequences are long-run effects which have their influence on the economy as a whole (see Table 14).

In its antitrust work, government seeks to curb monopolistic power and action in particular situations. Monopolistic power expresses itself in three principal ways: (1) discretionary control over price and the sale of goods at identical prices; (2) the withholding of supplies to *some* buyers (refusal to sell); and (3) the exercise of discrimination in pricing—that is, the making of sales at *higher* prices to some buyers and *lower* prices to others, at the same time.

[10] Report of the Industrial Commission, *Testimony* (Washington, 1901), Vol. 13, p. 453.

[11] J. Jewkes, "Monopoly and Economic Progress," *Economica*, August, 1953, pp. 213–214; *The Basing-Point Problem*, Monograph 42, Temporary National Economic Committee, 76th Congress, third session, 1941, pp. 4-5; A. G. B. Fisher, *Economic Progress and Social Security* (London, 1945), p. 81; Jacob Viner, "The Role of Costs in a System of Economic Liberalism," *Wage Determination and the Economics of Liberalism* (Washington, 1947), pp. 26-27; Howard S. Ellis, "Economic Expansion Through Competitive Markets," in *Financing American Prosperity* (New York, 1945), pp. 176–196, and "Monopoly and Unemployment," in *Prices, Wages, and Employment*, Board of Governors of the Federal Reserve System, Washington, D.C., May, 1946, pp. 67–94; William Fellner, *Monetary Policies and Full Employment* (Berkeley, Calif., 1946), pp. 83–94; and Moses Abramovitz, "Savings and Investment," *American Economic Review, Supplement*, June, 1942, pp. 81–86.

TABLE 14. Economic Effects of Monopolistic Restrictions

1. Monopolistic restraints levy a toll on consumer income in the form of higher prices and inferior quality.
2. They lead directly to lower incomes for workers, farmers, and other suppliers having weak bargaining positions.
3. They discourage technological progress and innovation.
4. They make for an uneconomic allocation of resources by restricting entry and by causing overexpansion in lines of business readily open to employment and investment.
5. They remove competitive pressures which make for efficiency in management.
6. They prevent a downward adjustment of prices and promote underutilization of capacity and underemployment. In depression periods, they operate to keep excess capacity unused. Where technological progress results in lower costs, they prevent increased output and lower prices.
7. They provide discretionary control over price and make it possible to raise prices, particularly during periods of high employment, in relation to those prevailing in other sectors of the economy.

UNITY OF ACTION ON PRICE

The primary purpose of unified selling is to secure "identity of price" in selling to a certain segment of buyers. By quoting only one price, it is possible to raise prices above the level which would result from competition.

Competition in selling has long been regarded as sound public policy designed to provide the buyer with a price advantage arising in the more favorable market position of some supplier, or from lower costs, more efficient methods, lower profit markups, or a more urgent need for sales. With unified selling by a group of persons, however, price can be raised and held at a higher level, for none can (or will) sell for less. When there are identical prices, the purchaser is denied any advantage which would result from genuine competition.

Likewise, in buying, unified action makes it possible for a group of buyers to "put the squeeze on price" and force down buying prices without fear, for none will pay more than the rest. Sellers, in this case, are denied any price advantage which would result from competition to buy desired goods.

The elimination of price competition in an industry may be accomplished *directly* by agreement among competitors (concerted action) or *indirectly* by various devices, practices, or methods (concurrent action). Price-fixing arrangements are the least costly method for suppressing competition. They do not involve the investment required in mergers, and they can be effected quickly. There is always the possibility, however, that some persons will not cooperate, and usually agreements on price are strengthened by the use of disciplinary devices such as local, discriminatory price cutting or the threat thereof.

When producing mills in different regions decide to act as one on price,

they face the problem of varying freight rates from each mill to given destinations. If geographically separate mills quoted a common f.o.b. mill price plus actual freight, the mills at greater distances from large consuming centers would be at a disadvantage in securing orders because of higher freight charges. To meet this problem, scattered producers in unified selling plans utilize some form of basing-point, zone-delivered, or freight equalization plan to equalize the element of freight.[12] These pricing mechanisms may be employed by agreement (*concerted* action) or by a mutuality of behavior without agreement (*concurrent* action).

The Basing-Point Formula

The basing-point plan is a method of price quotation by which a number of geographically separate sellers regularly and systematically arrive at identical delivered prices. The delivered price for any destination is determined by adding to a base price at a given point, called the basing point, the freight charge—usually rail freight—from such point to the point of delivery, regardless of the actual origin of the shipments or the actual freight cost incurred. All buyers at a given destination, accordingly, are given the same quotation. Rail freight is used in figuring delivered prices in order to insure identical delivered prices. If some mills used motor freight rates, some water freight rates, and others rail freight rates, the delivered prices would not all be the same, and competition would not be completely avoided.

Producers in a given industry may employ a *single* basing point for the entire country, or they may use *two or more* bases for the country. In some cases, every mill may be the governing base mill for its contiguous area. The base prices at the various base mills may be either equal or unequal. *Under the multiple basing-point system, each seller quotes a delivered price which is the lowest combination of a base price at any mill plus the rail freight from that mill to a particular destination.*

The price relationships of the multiple basing-point system are illustrated in Figure 14. A, B, and C are mills selling in their own localities, at other points, and in town E. Mills A and B are basing points. The base prices are equal, and the rail delivery costs are as shown on the diagram. The base at B is the governing base for sales in town E (since it provides the lowest combination price). Each mill will accordingly quote the base price at B plus the rail freight from B on sales in E and in adjoining territory. In selling at E, mill A will have its mill net reduced 5¢ by "freight absorption." *Freight absorption is the excess of the actual freight paid in making delivery over the amount of the freight item used in calculating the delivered price.*

When Mill C (Figure 14) sells at its point of production, it will quote the

[12] For a detailed analysis of basing-point and zone-delivered pricing systems, see Vernon A. Mund, *Open Markets* (New York, 1948), and "The Development and Incidence of Delivered Pricing in American Industry," *Law and Contemporary Problems*, Spring, 1950, pp. 141–158.

base price at B ($1.60) plus the rail freight from B to C (20¢), which gives a delivered price at C of $1.80. Since mill C charges its local customers a freight item of 20¢ per unit which it does not pay in making delivery, it collects a tribute in the form of "phantom freight." *Phantom freight is defined as the excess of the freight item charged over the freight actually paid*

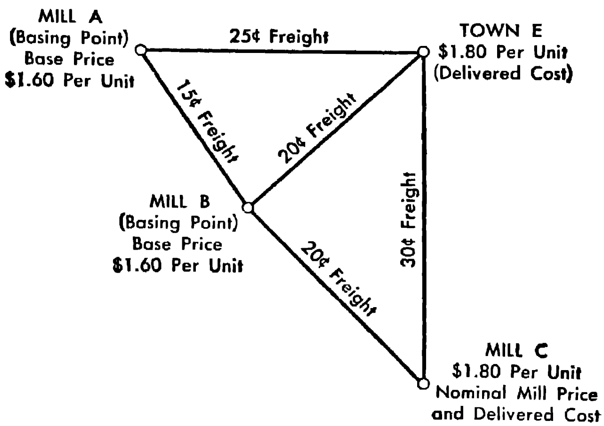


FIGURE 14. The Multiple Basing-Point System. This system is one in which base prices are established at two or more locations for use in selling goods at identical delivered prices. In using the basing-point system, each seller quotes a delivered price which is the lowest combination of the base price plus rail freight from that base to a particular destination. On sales in the territory contiguous to B, all mills quote the base price at B plus freight from that base to destination, whereas on sales in the neighborhood of A, all mills quote the base price at A plus freight from that base to a destination point.

It may be noted that in sales at E, all mills will quote the base price at B plus 20¢ freight from B (the lowest combination). Mill A must "absorb" 5¢ in freight. The basing-point practice is also called "competitive freight absorption" and "f.o.b. selling with freight equalization."

in making delivery. It may be noted that mill C continues to collect phantom or fictitious freight on all sales made up to a freight point halfway toward B, since it adds more freight on such sales than it actually pays out in making delivery.

The Freight-Allowed or Zone-Delivered Pricing System

A second type of delivered pricing formula is the "freight-allowed" or "zone-delivered" method of price quotation. When used jointly by two or

more sellers, this system also results in identical delivered prices and an avoidance of price competition.

Under the freight-allowed system, each seller quotes an identical base or zone price *containing an average freight item* and then "allows" the freight from his mill to destination. The delivered price so established may prevail for destinations anywhere in the entire country or within a specified zone. Sellers convert from f.o.b. pricing to delivered pricing by adding an "average freight item" to their f.o.b. prices. This is done by estimating what it has cost a seller, or a group of sellers, to ship the product to destinations in the particular zone or area for which a uniform price is being established.

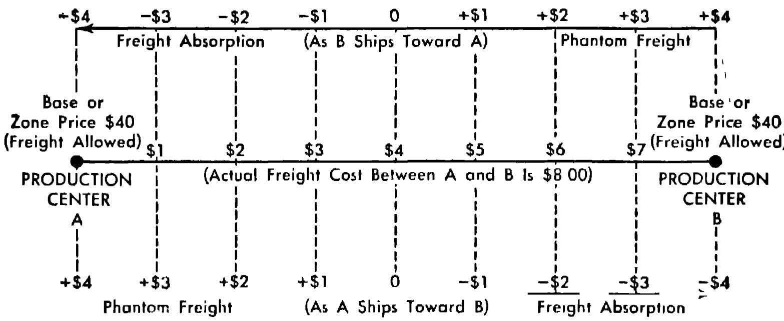


FIGURE 15. The Freight-Allowed or Zone-Delivered Pricing System. The base or zone prices include a sum to cover the "average freight" from the mill to the points in the zone, and a uniform price is made to all customers within that zone. In this example the average freight is assumed to be $4 per unit. The upper line shows the fictitious freight differentials of sellers at B as they ship toward A. Up to a point midway between the two production centers, sellers at B charge *more* for freight than the freight actually costs (phantom freight). In shipping beyond the midpoint, they charge *less* for freight than it actually costs (freight absorption). The lower line represents the fictitious freight differentials of sellers at A as they ship toward B.

In allowing freight, the goods may be sent prepaid or the buyer may be directed to pay the freight and deduct it from the invoice before remitting payment. Products sold freight allowed include some costing several thousand dollars and weighing many tons, as well as some of trifling cost and weight.

With a zone-delivered pricing system, customers living near a mill are required to pay an average freight item (essentially "phantom freight"), which the seller may use in part in absorbing freight and retain in part as a monopoly profit (see Figure 15). In the instance of a candy bar or a package of cigarettes, the phantom freight involved is of no practical significance. However, in the great majority of cases the delivery cost is a significant percentage of the product price, and the arbitrary collection of phantom freight

forces many buyers to pay prices bearing no relation to actual costs of delivery. A further criticism of all zone-delivered pricing systems is that they provide locally separate sellers with a formula for quoting identical delivered prices which effectively eliminates price competition.

REFUSAL TO SELL AS A MONOPOLISTIC PRACTICE

In open markets, with numerous buyers and sellers, a trader can count on buying under the same conditions open to others. Any given seller could refuse to sell, but he has no motive to do so, unless his supplies are exhausted or ready payment cannot be secured. If he did refuse to sell, a prospective buyer could quickly turn to another seller.

When, however, a producer, or group of producers acting in concert, controls a large proportion of the total supply of a market good, he (or they) can gain more by denying supplies to some persons in a given market and by raising prices (or increasing sales) in other outlets. Since the buyers excluded from sale are denied access to supplies, completely or partially, they are prevented or hindered in competition with the favored buyers who get the supplies for resale at prices which are not moderated by the excluded competition.

The practice of refusal to sell takes many forms (see also Chapter 9, pages 194–198). It is widely used by large integrated producers (producing primary materials and final products) in relation to unintegrated firms which compete with the former in the sale of finished products. Usually this refusal occurs during periods of rising business activity, when an integrated firm expands its production and undertakes to meet its own needs first. However, it may occur at any time, if the integrated company desires to limit or restrict the expansion of its rivals in the finished-products field.

Refusal to sell is used in many situations as a device for effecting unified action on price. Large integrated firms may deny basic supplies to independent fabricators who exercise any degree of independence on prices. Primary distributors may also deny supplies to certain customers who have competed on price with other customers in the resale market.

Refusal to sell is also practiced by large integrated firms controlling basic materials in selling only to fabricating "consumers" and not to independent dealers or speculators. Wholesale merchants typically accumulate heavy inventories during periods of low prices and then offer them for sale as demand increases. In order to prevent primary materials of their own production coming back into competition with them, large integrated firms typically refuse to sell anything at all to nonconsuming trade interests.

Refusal to sell, as a business practice, is an exclusive device and practice. It is a tool of monopoly which compels some would-be customers to restrict their business activity completely or partially. At the present time, the anti-

trust agencies report that refusal to sell is one of the most frequent complaints which they receive.[13]

PRICE DISCRIMINATION AND THE EXERCISE OF MONOPOLY POWER

In an open market, we have seen, the price of each seller is uniform to all his customers at a given time. Although a seller might like to charge an urgent or well-to-do buyer a higher price, he is not in a position to get away with it. He is held in line by price publicity and the opportunity of buyers to turn to other sellers willing to sell at a more moderate profit.

Under conditions of monopoly, however, a seller (or a unified group of sellers) has the power to make some buyers pay more than the price to others, for the group of buyers is unable in varying degrees to turn to another seller and get a better price. The making of a difference in the prices charged various buyers for the *same goods* without a corresponding difference in quality, service, or conditions in the terms of sale is known as *price discrimination.* Price discrimination may also exist when a seller does not make a difference in prices for a difference in the quality or service rendered. The phrase "conditions in the terms of sale" is concerned with whether the product is sold for cash or credit, in large or small quantities, and at retail or wholesale. Price differences which make only due allowance for difference in cost or value received—such as one price for cash and another for credit—are not considered to be discriminatory (see also Glossary of Terms at the end of this chapter).

The concept of price discrimination is usually applied to the making of a difference in the prices charged for *goods of like grade and quality* without a valid reason. A related discriminatory practice is the one in which a seller, handling many different products or product lines, cuts prices on a single product or product line, with small loss to himself, but with serious loss to small competitors who specialize in the product being subjected to price cutting. This is called the "loss leader" practice.

Price discrimination, economists have long observed, can be exercised by a seller only when he has some degree of monopoly power or when competition is substantially lessened or incomplete.[14] In open markets with price publicity a seller cannot ordinarily make some buyers pay more than the "going" price to other buyers for the same commodity. The existence of

[13] See Vernon A. Mund, *The Right to Buy,* Senate Document No. 32, 85th Congress, first session, 1957; and *The Right to Buy—1959,* Select Committee on Small Business, United States Senate, 86th Congress, first session, 1959.

[14] A. T. Hadley, *Transportation* (New York, 1903), pp. 101, 108; F. W. Taussig, *Some Aspects of the Tariff Question* (Cambridge, 1915), p. 208; Jacob Viner, *Dumping* (Chicago, 1923), pp. 1–3, 94–95; Frank A. Fetter, *The Masquerade of Monopoly* (New York, 1931), pp. 300, 411, 417; and *Discriminatory Pricing Practices in the Grocery Trade,* Department of Justice (Ottawa, 1958), pp. 14–15.

price discrimination is thus a sign and an indicator of some degree of monopoly or of incomplete competition.

Kinds of Discrimination

Discrimination Between Individuals. Price discrimination may be exercised as to (1) persons, (2) places, and (3) kinds of uses or commodities. A monopolist may, in the first place, endeavor to charge prices which approximate the reserve valuations of various individual buyers. Physicians, surgeons, and lawyers, having unique or specialized abilities, for example, frequently charge a higher price to some persons and a lower price to others, depending upon what the traffic will bear. In the industrial field, buyers with tremendous purchasing power are often able to secure more favorable prices than others by threatening to shift their business to another supplier.

Discrimination as to individuals was widely employed by the railroads to win the business of large shippers. In many cases, moreover, large shippers themselves brought pressure on a railroad company to secure special rates or rebates on the threat of transferring their business to another carrier. As a solution to this problem of special advantage, Congress provided in the Interstate Commerce Act of 1887 that all railroad rates should be publicly posted and uniform to all persons.

Discrimination as to Places—Geographic Discrimination. In the second place, a monopolist may discriminate between purchasers in different localities. The practice of domestic producers to discriminate between buyers in the United States and those in foreign nations—foreign "dumping"—has long beeen carried on in various monopolistic industries without government control or prohibition. A far more prevalent form of geographic discrimination is found in the practice of domestic producers to charge higher net prices on local sales than they receive on shipments into distant sales areas. This practice is known as domestic dumping.

The terms "local price cutting" and "cutthroat competition" came into use around 1900 to designate the practice of dominant firms in cutting prices in one area while maintaining them elsewhere. The shocking use of these practices by such firms as the American Tobacco Company and the Standard Oil Company brought growing demands for their abolition. In 1914, the House committee studying proposed legislation to prohibit unfair competition declared:

> In the past it has been a most common practice of great and powerful combinations engaged in commerce—notably the Standard Oil Co., and the American Tobacco Co., and others of less notoriety, but of great influence—to lower prices of their commodities, oftentimes below the cost of production in certain communities and sections where they had competition, with the intent to destroy and make unprofitable the business of their competitors, and with the ultimate purpose in view of thereby acquiring a

monopoly in the particular locality or section in which the discriminating price is made.

Every concern that engages in this evil practice must of necessity recoup its losses in the particular communities or sections where their commodities are sold below cost or without a fair profit by raising the price of this same class of commodities above their fair market value in other sections or communities.[15]

Discrimination Between Classes of Goods—One-Commodity Price Cutting. Discrimination may be practiced, in the third place, as to kinds of uses or commodities. A monopolistic seller of salt, for example, may make a difference in prices by selling the same salt under a "table brand," a "commercial brand," and a "livestock brand." A seller having monopolistic power in one line of goods may also cut prices on other kinds of goods in an effort to destroy the business of a competitor. The brand or product on which the price is cut is commonly called a "fighting brand" or a "loss leader."

The American Tobacco trust was one of many large combinations which used one-commodity price cutting to advance its monopoly position. This company had a dominating position in the cigarette business, but its plug business was small. As a weapon to crush out rival plug producers, the trust used its profits on cigarettes to slash prices on plug tobacco. A special brand of plug tobacco called "Battle Ax" was offered for sale, and prices to selected dealers were cut from 50¢ to 7¢ per pound. During a period of four years, the company suffered a net loss of some $3,300,000 on the sale of chewing tobacco, but this plan of discrimination enabled it to secure a monopolistic control of the chewing tobacco field.

It is common for associations of milk producers to use "multiple-price plans" or "use plans" for the sale of milk. The uses for milk—such as milk for fluid use, milk for cream separation, milk for cheese production, and so forth—are classified, and distributors are charged a different price for each class of use. All classes of milk are the same in quality, but the traffic will bear a higher price in some uses than in others.

In 1944 Wendell Berge, then Assistant Attorney General of the United States, reported that methyl methacrylate, one of the best-known plastics, controlled monopolistically by du Pont and Rohm and Haas, was being sold for industrial purposes at 85¢ a pound and for dental use at $45 a pound. In order to prevent dentists from purchasing their supplies from industrial users, Berge found that the monopoly sellers were considering the addition of a small amount of arsenic to the material sold to industrial users.[16]

Railroads and public utilities, especially, employ price discrimination as to kinds of commodities in their rate-making. A shipper of canned salmon, for example, must pay a higher price per hundred pounds for rail transportation

[15] Committee on the Judiciary, Antitrust Legislation, 63rd Congress, second session, House Report 627, May 6, 1914, pp. 8-9.

[16] Wendell Berge, *Cartels* (Washington, D.C., 1944), pp. 28-30.

than a shipper of coal. Public utility commissions usually regard discrimination between kinds of commodities as being more defensible than the other types (as to persons and places) on the ground that it is applied *uniformly* to all persons and areas *under public supervision* to provide a utility with a fair return on its investment.

The Overhead Cost Argument to Justify Discrimination

A common thesis advanced to explain and justify price discrimination is found in overhead cost analysis. Overhead costs are those which do not vary with the size of output and which cannot be directly traced to particular products—such as depreciation charges, taxes, general factory supplies, and executive salaries.

According to the overhead cost doctrine, when overhead costs are high, additional units can be sold at a lower price to some buyers, which covers variable cost plus a little of the overhead. The additional business, it is said, permits the large seller to spread his overhead costs and reduce his unit expenses.

It is undoubtedly true that high overhead costs may encourage an enterpriser to discriminate in price, provided he can get away with it. The important question to consider is "When can a concern discriminate in price?" It is a generally accepted economic principle that price discrimination can occur only when there is some degree of monopoly or incomplete competition. A seller (or a unified group) might like to discriminate to reduce unit expenses. It is fallacious to argue, however, that price discrimination is justifiable because it permits a dominant seller to secure greater profits.

In open markets, a seller cannot make some buyers pay more than the going price to other buyers because of price publicity and the action of buyers in quickly turning to other sellers when prices appear to be out of line. It is only under conditions of monopoly that a seller can make a difference in the prices charged various customers for the same product, for then customers are unable in varying degrees to turn to another seller.

Overhead costs exist even in the use of the simplest tools and machines, and are in some degree common in all industries. Overhead costs also constitute an important part of the costs in agriculture—but they do not condition pricing in that industry. Instead of overhead costs, the principal reason for discrimination in prices is the existence of some degree of monopoly power which enables a concern to get the higher price in certain areas or from certain customers.

Discrimination Increases Monopoly Profit

A large company practices discrimination, when it has the power to do so, because it can gain much more than it can by treating its customers alike. In Figure 16, for example, if one unit were sold at \$7, one additional at \$6,

another at \$5, and another at \$4, the total receipts would be \$22 rather than the \$16 secured at a uniform f.o.b. mill price. Moreover, if all the seven units were sold at discriminatory prices ranging from \$7 for the first unit, \$6 for the second, \$5 for the third, \$4 for the fourth, \$3 for the fifth, \$2 for the sixth, and \$1 for the seventh unit, the total receipts would be \$28 rather than the \$7 secured at a uniform price. In view of the greater profits which price discrimination brings, monopolistic sellers invariably try to work out some plan for classifying customers so that each group can be charged all that it is willing and able to pay.

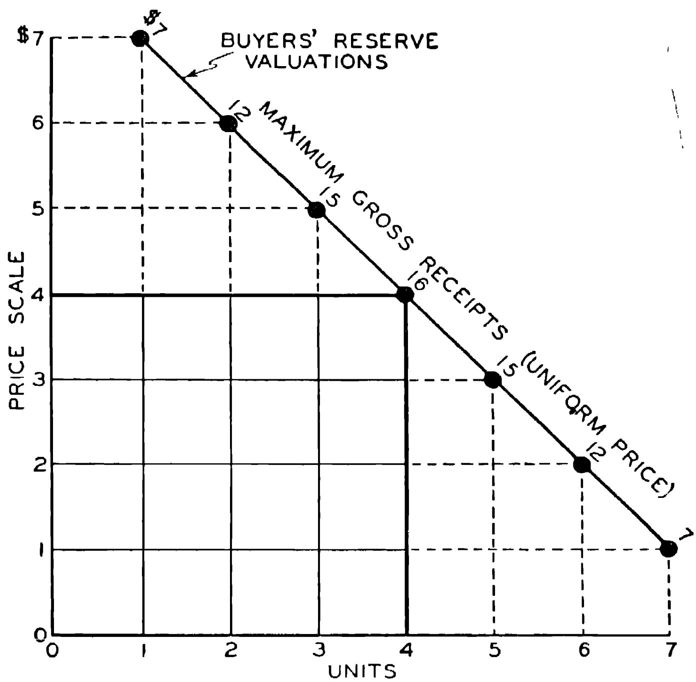


FIGURE 16. Market Demand Schedule. A seller possessing monopoly power is often in a position to sell at a series of discriminatory prices instead of at a uniform price. When discrimination is possible, it is usually practiced, because it yields more profit.

An incentive to discriminate typically develops when a manufacturer finds that he cannot sell all he can produce at the top prices he would like to get. Instead of cutting prices to *all* his distributors (as is done in an open market), the manufacturer finds an advantage in giving certain buyers a lower price. A selling outlet is thus secured, and it is unnecessary to take lower prices on all sales.

Discrimination is also practiced geographically to secure local monopoly gains. By charging high prices in areas where competition is "in its place" or

nonexistent, and by cutting mill net prices only where necessary to meet competition, a monopolistic seller can collect local monopoly profits. Non-uniform price reductions—limited to a few—do not reduce the net returns on all sales. Geographic discrimination also enables a seller to ship into distant areas, by cutting mill net prices on such sales, to keep distant competitors from growing bigger.

The Big-Buyer Argument for Price Discrimination

It is sometimes argued that price discrimination under conditions of large business size may contribute to some price competition and a more workable competition. When sellers are few and unified selling prevails, various sellers might like to reduce prices (to increase sales) but they are reluctant to do so (for fear of retaliation). Under these conditions, a large buyer (such as a retail chain) may be able to induce a supplier to grant a secret lower price on sales to it. This lower price may be passed on to consumers. In time the lower price charged may spread to other suppliers. Thus, it is reasoned, discrimination may promote the public interest.[17]

At first glance, the big-buyer argument for some discrimination may appear plausible. It considers, however, only one side of the coin. When a large buyer receives a discriminatory lower price, he secures a substantial cost advantage over his competitors (who pay the higher price). His smaller competitors have higher cost prices, and they cannot compete on an equitable basis in the resale market. The big firm can win regardless of productive efficiency.

The better approach to the problem of fewness of sellers and unified selling, many antitrust experts believe, is that of attacking directly the problem of dominant power by action to reduce company size.

Price discrimination is a limited kind of competition which is not comparable to that found in open markets. It operates, moreover, to injure competitors, so that the long-run effect is to reduce competition—not promote it.

Upon the basis of substantial evidence that price discrimination between purchasers placed some (these paying the higher price) at a serious disadvantage in relation to others (those paying the lower price), Congress in 1936 passed the Robinson-Patman Act. The essential purpose of this legislation is to provide small and big buyers with a comparable purchasing price, so that competition in the resale market can begin on a fair basis. In particular, the legislation makes price discrimination *between purchasers* illegal where the result may be "to injure, destroy, or prevent competition." The Robinson-Patman Act will be discussed in Chapter 14.

[17] For a detailed analysis of this view, see Joel B. Dirlam and Alfred E. Kahn, "Price Discrimination in Law and Economics," *American Journal of Economics and Sociology*, April, 1952, pp. 300–302; and "Antitrust Law and the Big Buyer," *Journal of Political Economy*, April, 1952, pp. 118–132.

Condemnation of Geographic Price Discrimination

Geographic or local price discrimination has long been condemned by economists on the grounds (1) that it denies customers located near a mill the advantage of their location and (2) that it enables a company enjoying local monopoly power to cut prices in a distant area expressly to injure a small firm which is trying to get established. In an effort to cope with the evils of geographic price discrimination in particular, Congress passed the Clayton Act in 1914. This act, as amended, condemns price discrimination where the effect "may be substantially to lessen competition." Its application will be discussed in Chapter 14.

At the present time, the antitrust laws do not place restraint on discrimination between different products or different product lines. A principal evil in this category is the "loss leader" practice. This is the practice in which a seller, handling many different products or product lines, cuts prices on a single product, with insignificant loss to himself, but with serious loss to small sellers who specialize in the sale of that product. As a remedy for this discriminatory practice, various experts have proposed that certain restraints be placed on price cutting, particularly at the retail level (see Chapter 19, pages 427–428).

PUBLICLY CREATED MONOPOLISTIC PRIVILEGES

In addition to monopolies secured by the action of private individuals, there are monopolistic privileges granted by government. These include patents, copyrights, and franchises, as well as monopolistic enterprises owned and operated by government itself.

The monopoly power exercised by a legalized monopoly is usually an absolute power in one or more important respects. A national match monopoly, for example, is absolute in respect to time, place, and the kind of product. No one else may enter the field, anywhere in the nation, to produce any kind of match. So, likewise, a franchise gives an electrical utility an absolute right to sell electricity in the local community. The power of the company to manage prices as its own interests dictate, however, is limited by public control.

By way of contrast, private monopoly power is always a relative and limited power. It is relative to space—a local or regional sales area—and its exercise is always limited by the presence of other sellers at a distance, by substitutes, and by the possibility of potential competition.

The monopoly rights secured in patents and copyrights, it may be noted, are limited rights; subject to a superior law enacted in the public interest; i.e., the Sherman Antitrust Act. As Justice Douglas said in the Masonite case (1942), quoting from the Standard Sanitary case (1912), patent rights "do not give any more than other rights a universal license against positive pro-

hibitions. The Sherman Law is a limitation of rights, rights which may be pushed to evil consequences and therefore restrained."[18]

The granting of exclusive or special privileges to authors and inventors is based upon the constitutional authority of Congress "to promote the progress of science and useful arts by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries" (Art. 1, Sec. 8). The essential idea behind the granting of copyrights and patents is that the privilege of exclusive use will stimulate and encourage authors and inventors to exert themselves in creative work. By granting an exclusive control over innovations, moreover, it is believed that there will be a greater willingness to disclose trade secrets which might otherwise be kept from public knowledge.

Patents, copyrights, and trademarks are classed as measures for the protection of "intellectual property" or "industrial property".[19] Patents provide an exclusive right to inventors of new products, processes, or designs for a period of seventeen years. The patent system will be discussed in Chapter 12.

Copyrights

The word "copyright" literally means the "right to copy." Copyright legislation gives an author the exclusive right to print, publish, or copy his work. No one else can do so without his permission. A United States copyright is valid for twenty-eight years, and a second term of twenty-eight years may be secured by making a renewal during the final year of the first term. Copyrights are issued by the Copyright Office, Library of Congress, Washington, D.C.

Works which may be copyrighted include books, periodicals, lectures, dramatic and musical compositions, maps, works of art, drawings, photographs, prints, and motion pictures. Ideas may not be copyrighted.

A copyright prevents another from copying a literary work and thus gives the author—or one securing the right from an author—a monopoly privilege. Under the state resale price-maintenance laws, the owner of a copyright is privileged to fix resale prices on his identified product. The prices of many books are so controlled.

Trademarks and Product Differentiation

Basically, a trademark is a name or symbol used to indicate the source or origin of certain goods. Trademark rights prevent others from using the same name on the same goods. They do not, however, prevent one from making the same goods without using the trademark. Trademarks are registered in the United States Patent Office, Washington, D.C. They are issued

[18] *U.S.* v. *Masonite Corp.*, 316 U.S. 265, 282 (1942).

[19] See also Fritz Machlup, *An Economic Review of the Patent System*, Committee on the Judiciary, United States Senate, 85th Congress, second session, 1958, p. 1.

for a period of twenty years, and they may be renewed indefinitely for periods of twenty years if they are in use at the time of renewal.

An early practice of merchants was to identify their merchandise with symbols or marks, and in time the common law protected individuals in their use of particular marks. In doing so, the law sought to protect a seller, as well as the public, against the "passing off" of other goods as his products. The true function of trademarks, legal authorities agree, is to show the *origin* or *ownership* of a product.

Today trademarks are used chiefly to *differentiate* products rather than to identify their source. Thousands of people, for example, who prefer "Camel" cigarettes or "Del Monte" canned peaches do not know the identity of the producer. In differentiating a product, a seller seeks to get consumers to buy it without comparing it with the products of other sellers. With product differentiation *and an absence of quality guides to inform consumers about the product*, extensive advertising may be used to educate consumers into believing that the product has a halo around it and is superior to all others. A seller is thereupon able to charge a substantial group of buyers a few cents more for his product without having them turn to another seller. Since no one else can sell the branded product, a trademark thus gives a seller various degrees of monopoly power.

In discussing the use of trademarks, it is important to note that the issue is not one of trademarks or no trademarks, but rather one of standardization versus product differentiation. If staple consumer goods—such as canned fruits and vegetables, women's hosiery, and tobacco products—were graded as to quality and grade-labeled, sellers could still use trademarks to designate *origin or ownership*—the true legal purpose of trademarks. They would not, however, be able to use advertising to exploit the technical ignorance of consumers by leading them to believe that a particular product is better than it really is.

Lanham Act of 1946

The first effective registration act for trademarks was passed in 1881. Many trademarks have been in continuous use since that date.

In 1946 Congress repealed prior trademark laws and provided for the legal right to register any mark which has become distinctive—not merely those which show origin or ownership.

The Trademark Act of 1946 defines a trademark as "any word, name, symbol, or device, or any combination thereof adopted and used by a manufacturer or merchant to identify his goods." Some examples of well-known trademarks which have been registered with the Patent Office are shown in Figure 17.

The act of 1946 also makes provision for the registration of "service marks," "certification marks," and "collective marks" (see Figure 17). Serv-

Trademarks

KODAK
CAMEL
OLD GOLD
CHESTERFIELD
FORD
CHEVROLET
WESTINGHOUSE
GENERAL ELECTRIC
HART, SCHAFFNER & MARX

Certification Marks

ALLIED PRINTING
TRADES UNION LABEL COUNCIL

ROQUEFORT

The Community of Roquefort, Aveyron,
Roquefort, France

Service Marks

GREYHOUND

Santa Fe

Collective Mark

N·A·P·A

National Automotive Parts Association,
Detroit, Mich.

FIGURE 17. Some Well-Known Trademarks, Service Marks, Certification Marks, and Collective Marks. Certain types of marks cannot be registered. These include marks which are immoral, scandalous, or deceptive. Otherwise, the act of 1946 provides for the registration of a mark "which has become *distinctive* of the applicant's goods in commerce." Such marks include names, words, figures, letters, symbols, devices, and the like. (Source: United States Patent Office)

ice marks are essentially trademarks which are used in connection with a service business. Certification marks consist of seals of approval or union labels which indicate that the designated goods are union-made. Collective marks, on the other hand, are marks used by members of an association or other collective groups.[20]

[20] "Trade-Mark Act of 1946" in *Rules of Practice in Trade-Mark Cases,* Patent Office, United States Department of Commerce (Washington, 1947), pp. 81-116. The Lanham Act also provides for registration on a *Supplemental Register* of "any trade-mark, symbol, label, package, configuration of goods, name, word, slogan, phrase, surname, geographical name, numeral, or device or any combination of any of the foregoing." This registration serves only as a basis for registration in foreign countries. Many foreign countries permit Americans to register marks if they are registered in the United States.

ence in the costs of manufacture, sale, or delivery which are applicable to each product.

Cutthroat Competition; Predatory Competition. A uniform or a discriminatory cutting of prices expressly to injure a competitor. In cutting prices locally, a dominant firm usually keeps up or raises prices elsewhere. Thereupon, when the smaller competitor has been disciplined or put out of business, prices are raised in the area of local cutting.

8

The Sherman Act of 1890

THE BASIC LAW ON MONOPOLY AND COMPETITION

The Sherman Act of 1890 is the Magna Carta which dedicates the federal government to the economic policy of preventing monopoly and maintaining competition. In the three ensuing chapters, we shall study the background of the act, its essential provisions, its application to business, and its administration by the Antitrust Division, Department of Justice.

The original law in the United States with regard to monopoly and competition came from the English common law on markets and freedom of enterprise. The English common law, in turn, was developed by judges in hearing the complaints of people on the evils of private monopoly. Agreements among sellers on price were held to be criminal conspiracies, punishable by fines and imprisonment. In 1300, for example, the candle dealers in Norwich, England, were fined for making an agreement among themselves "that none shall sell a pound of candle at less than another."[1] Price-fixing agreements were condemned because they worked "to the great impoverishment of the people." Similarly, the action of one or several sellers in buying up the whole or a large part of a commodity (engrossing) was held to be a market offense because it made for a withholding of supplies and higher prices.

The term "restraint of trade" was applied in the common law to designate restraint on the freedom of a producer to exercise a trade of his own choice. The term "trade" was used to mean a person's craft, business, or profession. At first, the common law forbade *any* restraint on the freedom of a person to exercise his trade. Gradually, however, the rule was developed that partial restraints on trade made by a person in selling his business are valid if they are reasonable and based upon a consideration.[2]

[1] *Leet Jurisdiction in the City of Norwich*, p. 52, in Selden Society Publications, London, 1822.

[2] The leading case establishing this rule was *Mitchell* v. *Reynolds* (1711), 1 P. Wms. 181, 24 Eng. Rep. 347.

SPECIAL MEANING ATTACHED TO THE WORD "MONOPOLY" IN THE ENGLISH LAW

It appears that the word "monopoly" was first introduced into England in 1516 by Sir Thomas More in his book *Utopia*. More used the word at that time to describe the price-fixing activity of the financially dominant guildsmen. He declared: "Suffer not these rich men to buy up all, to engross and forestall, and with their monopoly to keep the market alone as please them."[3] The original edition of *Utopia* was in Latin, but the term "monopoly" soon was introduced into popular use and came to be widely employed in England to designate the action of one person or a group of persons "acting as one" in controlling supplies, limiting production, and enhancing prices.

In 1602 the term "monopoly" was added to the English law to describe the patents which Queen Elizabeth had been granting to her favorites for the exclusive manufacture and sale of many products other than new inventions. This abuse of the prerogative of government to encourage and reward inventors, designers, and writers led to widespread protests not only by consumers who were injured by high prices but also by enterprisers and workmen who were excluded from a common calling. The validity of the queen's grants was appealed to the high court in the case of *Darcy* v. *Allen* (1602).[4] In its decision the court held that a public grant restricting a trade to one or a few persons was void because it was a *monopoly*. Monopoly, the court stated, makes for higher prices, cheaper quality, and the loss of employment by persons formerly engaged in the trade. Since acts which have these consequences were against the common law, the court reasoned that monopoly was contrary to the common law.

The ruling of the court in *Darcy* v. *Allen* was embodied in statute law in the famous Statute of Monopolies (1624). The purpose of this legislation was to strengthen the control of Parliament over the granting of patents by the king. Its preamble declared that "all grants of monopoly are against the ancient and fundamental laws of this kingdom." A monopoly was defined in the law as an exclusive grant from the king for the doing of something which was before of common right. Exceptions in the statute were made for patents on new inventions, special charter rights, and other designated privileges which were not regarded as monopolies.

Thus it was that the term "monopoly" in the English law came to have a very narrow and restricted meaning—namely, a *public grant* which restrained the exercise of a lawful trade to one or a few people. The English law already had the terms "forestalling," "engrossing," and "conspiracy on price" to designate the exercise of monopoly power by private acts, and "mo-

[3] Thomas More, *Utopia* (1516), Book 1, p. 18 (Lupton edition, 1895).

[4] *Darcy* v. *Allen*, King's Bench, 1602. 11 Co. Rep. 84; Moore, K. B. 671, Noy, 173, 77 Eng. Rep. 1260.

nopoly" was added to take care of a special political situation in which the power of government was used to restrict competition.

USE OF THE TERMS "MONOPOLY" AND "RESTRAINT OF TRADE" IN AMERICAN LAW

The peculiar meaning attached to the term "monopoly" in England was transferred to America, and for many decades the American courts used the word in its specialized, restricted sense. Justice Story in the Charles River Bridge case (1837), for example, defined monopoly as "an exclusive right granted to a few, of something which was before of common right."[5] Subsequently, the term was also used to describe a public franchise granted by the legislature for a public benefit.[6]

The common-law doctrine of restraint of trade was likewise introduced into the American law. In the earliest reported case on this subject (1811) the defendant had agreed not to run a stage between Boston and Providence in opposition to the plaintiff's stage. The court held this contract in restraint of trade to be valid, saying that "bonds to restrain trade in particular places may be good if executed for a sufficient and reasonable consideration."[7] In the next reported case on restraint of trade (1837), a craftsman bound himself never to carry on, or to be concerned with, the business of iron founding. The court held this contract to be a general restraint and void.[8] A further example is found in the case of *Whitney* v. *Slayton* (1855), in which the defendant upon selling his iron foundry agreed not to engage in the business of iron casting within sixty miles of the plant for a period of ten years. The court held that this partial restraint was reasonable and valid.[9] So it was that the courts in the United States, as well as in England, developed the doctrine that (1) all *general* restraints are illegal and (2) *partial* restraints —as to time or place—are valid if made for a valuable consideration in the sale of one's business or property. This doctrine on contracts in restraint of trade is essentially the present rule of law.

ADOPTION OF THE ECONOMIC DEFINITION OF MONOPOLY INTO THE LAW

The development of "trusts" and combinations of producers in many lines of business soon after 1880 brought much popular condemnation of the mo-

[5] *Charles River Bridge Co.* v. *Warren Bridge Co.*, 11 Peters 402, 607 (1937).

[6] *Camblos* v. *Philadelphia and Reading R.R.*, 9 Phila. (Pa.) 411 (1875).

[7] *Pierce* v. *Fuller*, 8 Mass. 223 (1811).

[8] *Alger* v. *Thacher*, 36 Pick. 51 (Mass. 1837).

[9] *Whitney* v. *Slayton*, 40 Maine 224 (1855). There are three elements of a valid restraint of trade at common law. First, it must be only partial—as to time or place. Second, it must be founded upon a consideration. Third, the partial restraint must be reasonably appropriate—or directly related—to the consideration for which it is exchanged.

FIGURE 18. An Illustration of the Use of the Term "Monopoly" in Popular Discussion in 1881 to Describe "Trusts" and Combinations Among Competitors Affecting Prices. This idea of monopoly was adopted by the higher state courts in the United States in 1889. (The Bettmann Archive)

nopolies which private individuals were creating *by their own acts* (see Figure 18). Monopoly, it was seen, could be attained by private agreements, as well as by public grants of special privilege. This idea found its way into American law in the North River Sugar case decided in 1889. The Sugar case involved the legality of a "trust" formed for the purpose of controlling the prices and sales policies of all the sugar refineries in the United States. The New York Court of Appeals held that the arrangement was against public policy and subject to dissolution. In its words, "The board, under this executed deed, can close every refinery at will; close some and open others; limit the purchase of raw materials; artificially limit the production of refined sugar; enhance the price to enrich themselves and their associates at public expense; and depress the price when necessary to crush out and

impoverish a foolhardy rival; *in brief, can come as near to creating an absolute monopoly as is possible under the social, political, and economic conditions of today.*"[10]

In 1889 a case decided by the Supreme Court of Michigan likewise held that a business combination organized for the purpose of controlling the production and prices of matches was a monopoly and against public policy. According to the Court, "All combinations among persons or corporations for the purpose of raising or controlling the prices of merchandise . . . are monopolies, and intolerable, and ought to receive the condemnation of all courts." Further, the Court observed: "Indeed, it is doubtful if free government can long exist in a country where such enormous amounts of money are allowed to be accumulated in the vaults of corporations, to be used at discretion in controlling the property and business of the country against the interest of the public and that of the people, for the personal gain and aggrandizement of a few individuals."[11]

ENACTMENT OF THE SHERMAN ACT BY CONGRESS IN 1890

Increasingly the "trusts" and combinations being formed in the United States were coming to be national in their scope and field of operations. The various state governments seeking to prosecute monopoly, moreover, found themselves unable to reach the controlling units chartered by and located in other states. The prevention of monopoly and the maintenance of competition, it was widely recognized, had become a national problem calling for federal intervention. In the presidential election of 1888, this view was expressed in the campaigns of both the Democratic and the Republican parties. The platforms of both parties also promised federal intervention to control trusts and monopolistic combinations. "All who recall the condition of the country in 1890," wrote Justice Harlan some years later, "will remember that there was everywhere, among the people generally, a deep feeling of unrest. The nation had been rid of human slavery—fortunately, as all now feel—but the conviction was universal that the country was in real danger from another kind of slavery sought to be fastened on the American people, namely, the slavery that would result from aggregations of capital in the hands of a few individuals and corporations controlling, for their own profit and advantage exclusively, the entire business of the country, including the production and sale of the necessaries of life."[12]

A survey of the forces leading to the actual adoption of the Sherman Act indicates that the Republican leaders took the initiative in securing its enact-

[10] Reported with an affirming decision by the Supreme Court of the State of New York in *People* v. *North River Sugar Refining Co.*, 54 Hun (N.Y.) 354, 376 (1889). Italics supplied.

[11] *Richardson* v. *Buhl*, 77 Mich. 632, 658 (1889).

[12] *Standard Oil Co. of New Jersey* v. *U.S.*, 221 U.S. 1, 83 (1911).

ment because they wanted something at that time to offset the opposition of the agricultural interests in the West to the high tariffs which the Republican Congress was then enacting. The Democrats were contending that the "tariff is the mother of trusts," and the Republicans replied with the idea that the nation could have "protection" and a policy of competition, too. Both the Republicans and the Democrats in Congress were in agreement that the principle of competition should be maintained by the federal government, and the act "to protect trade and commerce against unlawful restraints and monopolies" accordingly became law on July 2, 1890, with unanimous approval in the House and with only one dissenting vote in the Senate.

It is frequently said that the Sherman Act made contracts and conspiracies in restraint of trade or commerce explicitly illegal, whereas they were only void or unenforceable at common law. This view is correct with respect to contracts in general or unreasonable restraint of trade. Contracts or conspiracies to fix the price of necessaries, however, from earliest times were held at common law to be criminal offenses, punishable by fines and imprisonment.[13] The records of Congress indicate that the really important feature of the Sherman Act is the fact that it dedicated the federal government to the policy of maintaining the principles of market price and fair competition with reference to interstate commerce. In the words of Senator Hoar, "the great thing that this bill does" is to establish the common-law principles "which protected fair competition in trade in old times in England." Standards for fair competition were not specified in the law. Rather it was left to the federal courts to develop and apply such standards and rules as were found to be necessary to preserve price competition and to prevent monopoly.[14]

From 1890 to the present time, the Republican and Democratic parties have both supported the Sherman Act and the principles which it embodies. The major parties have differed in the effectiveness of their enforcement activities, but neither one has proposed a different economic policy for the nation. In this regard, the United States, along with Canada, stands largely alone in the world in seeking to maintain a system of economic freedom.[15]

[13] See *King* v. *Norris*, King's Bench, 1758. 2 Kenyon 300, 96 Eng. Rep. 1189.

[14] The terms "fair competition," "price competition," and "monopoly" are economic concepts, and a successful administration of the antitrust laws depends basically upon a clear and sound understanding of the economic principles underlying the laws. It has been said that antitrust cases are typically 95 percent economic and 5 percent legal in their nature.

[15] England and the continental countries all formerly had laws—common law and statute law—providing for the maintenance of competition, the creation of markets, and the prevention of monopoly. See W. A. Bewes, *The Romance of the Law Merchant* (London, 1923), pp. 124-125, and Josef Kohler, *Der unlautere Wettbewerb* (Berlin, 1914), p. 3. The growth of monopolistic guilds and companies during the sixteenth century, promoted by the fiscal needs of the rulers, however, served as focal points for breaking down these market rules and customs. See also Vernon A. Mund, *Open Markets* (New York, 1948), pp. 24–28, 74 94.

ESSENTIAL PROVISIONS OF THE SHERMAN ACT

There is general agreement that the purpose of the Sherman Act is to prevent monopoly and preserve and maintain the institutions of free entry and price competition. The principal factors in 1890 restricting and limiting competition were (1) conspiracies on price, (2) the existence of "trusts," and (3) the formation of corporations to acquire the stock or assets of independent competing companies. The two main prohibitions of the law, accordingly, were aimed particularly at these restraints. They declare:

Sec. 1. "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations is hereby declared to be illegal. . . ."

Sec. 2. "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanor. . . ."[16]

The third section of the act makes its provisions specifically applicable to commerce in any territory of the United States and in the District of Columbia, as well as to the commerce of these areas with the states or with foreign nations. In *People of Puerto Rico* v. *Shell Co.*, 302 U.S. 253 (1937), the Supreme Court held that the word "territory" should be construed in its most comprehensive sense to include a dependency such as Puerto Rico. "When the Sherman Act was passed (1890)," the Court stated, "we had no insular dependencies; and, necessarily, the application of section 3 did not extend beyond our continental domain." The Court reasoned that Congress meant to give the Sherman Act a broad application, and that it was logical to infer that Congress intended to include all areas to which its powers might extend.

THE SHERMAN ACT FOLLOWS UNITED STATES CORPORATIONS ABROAD

The Sherman Act, it may be noted, applies to "trade or commerce . . . with foreign nations." In *U.S.* v. *American Tobacco Co.*, 221 U.S. 106 (1911), the Supreme Court condemned an agreement "executed in England" by an American combination and the Imperial Tobacco Company to allocate territories. Although the agreement was presumably legal under British Law, the court found that it affected the commerce of the United States and was illegal under the Sherman Act. Similarly in the Timken case, 341 U.S. 593 (1951) the court declared that arrangements made abroad by

[16] *United States Code*, 1946 ed., Title 15, Sections 1-8. Hereafter cited as 15 U.S.C. 1-8. The full text of all the antitrust laws may be secured in pamphlet form from the Superintendent of Documents, United States Government Printing Office, Washington 25, D.C.

American Timken and its foreign competitors, limiting competition in the United States and abroad, were illegal.

In the Alcoa case, 148 F. (2d) 416 (1945), the Court of Appeals raised the question of whether *foreign* corporations operating abroad can be reached by the Sherman Act. The question, Judge Hand stated, is "whether Congress chose to attach liability to the conduct outside the United States of persons not in allegiance to it." In holding that a foreign agreement which had an influence on prices in the United States was illegal, the court declared, "it is settled law . . . that any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has consequences within its borders which the state reprehends."[17]

There is always the question whether it is possible to institute a United States court proceeding against an antitrust violator who is located outside of the boundaries of the United States. A court proceeding is possible only if the federal government is able to obtain jurisdiction over the foreign violator of the antitrust laws. To obtain jurisdiction, it is necessary for a branch office or subsidiary of a foreign wrongdoer to be "present" in the United States and to be carrying on business in this country.[18]

PUBLIC REMEDIES UNDER THE SHERMAN ACT

All violations of the first three sections of the act are subject to criminal penalties, and provision is made for punishment by fine not to exceed $50,000 for each violation, or by imprisonment not to exceed one year, or both. Upon conviction, the fine of $50,000 may be levied against each party indicted and for each count (charge) in the complaint. In given cases, fines have been levied against (1) a trade association, (2) every member of the trade association, (3) the officials of the trade association, (4) the top officers in the corporations involved, and (5) the boards of directors of the corporations. Fines have also been levied on the several counts of (1) monopolization, (2) attempts to monopolize, (3) conspiracy, and (4) restraint of trade. By such means, the fine of $50,000 for each violation has been pyramided into a total fine of $451,000.

Prison sentences of one year per count have been imposed in many cases. The shortest prison sentence was four hours; and the longest was three years on three counts, to run consecutively. Prison sentences have generally been accompanied by fines.

[17] In commenting on the Alcoa case, the *Attorney Generals' National Committee to Study the Antitrust Laws* (1955), states: "we believe that conspiracies between foreign competitors alone should come within the Sherman Act only where they are intended to, and actually do, result in substantial anticompetitive effects on our foreign commerce" (*Report*, p. 76).

[18] *U.S.* v. *Watchmakers of Switzerland*, 133 F. Supp. 40 (1955) and 134 F. Supp. 710 (1955).

Criminal cases are essentially punitive in their nature. They seek to penalize past illegal conduct—mainly conspiracies—and to prevent a repetition of such conduct. In criminal cases, it is possible for a defendant to plead *nolo contendere* ("I will not contest it") with the consent of the court. This plea means that the accused party makes no contention as to whether or not he is guilty and agrees to accept the decision of the court. Actually, a plea of *nolo contendere* is tantamount to a plea of guilty. If the court accepts the plea, it is in a position to impose criminal penalties according to the provisions of the law.

The fourth section gives the Attorney General the power to enforce the act by civil proceedings to restrain, enjoin, and prohibit violations of the act. Civil actions do not involve penalties, but they do make it possible for the federal government to restore competitive conditions by requiring modifications in business organization and practice.

The government may bring either a criminal or civil action against a defendant or group of defendants, and the two actions may also be pursued concurrently or successively. In civil cases a company charged with violating the Sherman Act may decide that it is quite certain that it will lose the case. In this event, the company frequently arranges with the court and the Department of Justice to sign a *consent decree* without a presentation of its case to the court. The defendant, in other words, consents to accept a court order without having been found guilty of violating the law. Consent decrees are usually worked out by negotiation between the Department of Justice and the defendant and are enforceable by means of contempt proceedings. In the event that the defendant is not satisfied with the proposed modifications for his business behavior, he can always ask to have the case brought to trial.

The closing of cases by *nolo contendere* settlements and consent decrees, rather than by actual litigation, frequently saves time and money. Experience has shown, however, that these procedures make for a weak application of the Sherman Act (see Chapter 10, pages 210–211).

It is in civil suits that the Department of Justice can make provision for a dissolution, divestiture, or divorcement of corporate mergers in order to create numerous, independent competitors (see Chapter 9, pages 198–203). Affirmative relief may also include the compulsory licensing of patents, either royalty free or at a reasonable royalty. The civil remedy further includes the use of injunctions to forbid various business practices—such as interlocking directorships, exclusive dealing contracts, and restrictive patent agreements. Injunctions may likewise contain mandatory provisions which are positive in their nature—such as compulsory selling orders, even though such measures are not specifically required by law.

Section 6 provides that any property owned by an illegal combination or a group of conspirators which is in the course of interstate or foreign commerce may be seized by the federal government.

PRIVATE REMEDIES UNDER THE SHERMAN ACT

The seventh section provides that any person "injured in his business or property" by anything forbidden in the act, may sue to recover threefold the damages sustained, including the costs of the suit. This is the important "treble damages" section of the law. Its purpose is to encourage private individuals injured by monopoly to take action, themselves, in enforcing the statute. A second private remedy against the monopolistic practices prohibited by the Sherman Act is provided in Section 16 of the Clayton Act (1914). This section enables a private plaintiff to sue for an injunction—a restraining order—whenever he is threatened by loss or damage by a violation of the antitrust laws. For data on the use of the treble-damage section of the Sherman Act, see Chapter 10, page 212.

JURISDICTION UNDER THE SHERMAN ACT

The fourth section of the law provides that the several district courts of the United States (originally designated as circuit courts) shall be invested with jurisdiction to prevent and restrain violations of the act. Such courts also have jurisdiction of the criminal and seizure sanctions, as well as both of the private remedies created by the Sherman and Clayton Acts. The higher federal courts—courts of appeal and the Supreme Court—affirm antitrust decisions upon appeal or reverse and remand them to the district courts for final disposition.

The fifth section of the act gives a federal court hearing an antitrust case authority to require all persons connected with the alleged violation to come before it even though they do not reside in the judicial district in which the court is sitting. The eighth and last section of the act defines "person" or "persons" to include corporations and associations.

SOCIAL PHILOSOPHY OF FEDERAL JUDGES AND THE INTERPRETATION OF THE SHERMAN ACT

It has frequently been observed by distinguished lawyers that the Sherman Act, like the Constitution, is what the judges say it is. Though we all want a government of law, the fact is that there is no way to attain that end except through men. The background, training, associations, and social philosophy of the judges interpreting the law are thus of exceedingly great importance in determining the use and application of the legislation passed by Congress. A "procompetition" statute will be of small effectiveness if the judges are not procompetition in their point of view.

The prevailing economic philosophy of politically important people in the United States, from the adoption of the Constitution to the "New Deal" policies of President Roosevelt, was that government should largely pursue

a policy of "let alone" with respect to the conduct of business activity. In accordance with a policy of economic freedom, it was thought, businessmen should be permitted to create their own methods of competition and their own "rules of the game." This view, in large measure, arose as a reaction to the restrictive policies of English "mercantilism" and from a desire not to be hampered in the pursuit of profit.

EARLY APPLICATION AND INTERPRETATION OF THE SHERMAN ACT

The Sugar Trust case of 1895 was the first important case to arise under the Sherman law. In its decision on this case, the Supreme Court through Chief Justice Fuller conceded that the American Sugar Refining Company had "acquired nearly complete control of the manufacture of refined sugar in the United States." Nevertheless, the Court held that the Sherman Act could not be applied to a combination of *manufacturing* enterprises, on the ground that manufacturing is not commerce. Even though in disposing of its product the combination had to resort to interstate commerce, the Court held that a combination of manufacturing plants, in itself, "bore no direct relation to commerce between the states."[19] As a result of this decision the control of industrial monopolies was left entirely to the states. Since the state legislatures were then largely under the domination of the large corporations, the effect of the decision was to allow industrial monopoly in the United States to grow without abatement. Indeed, it was during the years immediately following the Sugar Trust decision that many of the formerly competing and independent enterprises of the country were united together to form the giant corporations of today.

After some years, the Court began to modify its extreme view that manufacture and commerce are separate and distinct. In the Addyston Pipe case (1899), it applied the Sherman Act to six pipe manufacturers who had agreed to fix prices. Again, in the Beef Trust case (1905), the Court condemned a collusive combination of meat packers which had virtually eliminated price competition in the purchase of livestock and the sale of fresh meat in the Middle West. In a unanimous decision Justice Holmes declared: "The very point of the combination is to restrain and monopolize commerce among the states in respect to such sales."[20]

THE SHERMAN ACT AND CONSPIRACIES TO RESTRAIN COMPETITION

In the common law, all agreements among competitors with respect to the prices of necessaries were held to be illegal "conspiracies." This rule

[19] *U.S.* v. *E. C. Knight Co.*, 156 U.S. 1, 9 (1895).
[20] *Swift and Company* v. *U.S.*, 196 U.S. 375, 397 (1905)

against price fixing was made applicable in American law to all products. In developing the common-law rule on price fixing, the judges were not concerned with whether the prices were high or low. The mere fact that two or more sellers had agreed on prices was sufficient to make the action illegal. The purpose of the law was to maintain and preserve price competition in order to insure fair and equitable prices and incomes. Since an agreement on price eliminates price competition, there was no ground for modifying the prohibition in any degree. The common-law doctrine on conspiracy was incorporated into the Sherman Act, and Section 1 specifically states that "every . . . conspiracy in restraint of trade or commerce . . . is illegal."

Today, cases involving concerted action among nominally independent firms are called "conspiracy cases." According to the Supreme Court, a conspiracy is "a combination of two or more persons, by concerted action, to accomplish a criminal or unlawful purpose."[21] More briefly, Justice Holmes has stated that "a conspiracy is a partnership in criminal purposes."[22]

DIRECT PRICE FIXING

Statement of Present Rule of Law

Any agreement, collusive restraint, concerted action, or understanding among competitors, in or affecting interstate commerce, fixing the prices of goods sold or purchased, is unlawful under Section 1 of the Sherman Act, whether or not the price so fixed is reasonable.

The rule on conspiracies suppressing price competition was early applied by the Supreme Court in the Addyston Pipe case (1899).[23] In this case, six pipe manufacturers, controlling some 30 percent of the national production of cast-iron pipe, divided sales territories and fixed selling prices. The Court condemned the agreement, stating that the direct and immediate effect of price-fixing conspiracies is to destroy competition, so that the parties may secure increased prices for themselves.

Evidence presented at the trial indicated that the prices of pipe were raised a third more than they might have been with independent price competition. The decision in the case, however, did not turn on whether or not the "managed prices" were reasonable or unreasonable. In the opinion of the Court, an agreement to fix prices is, in itself, a restraint on interstate commerce and illegal.

The law thus stated has been consistently followed by the courts. Today it may be said that *concerted* action to fix prices, divide sales areas, deny

[21] *Pettibone* v. *U.S.*, 148 U.S. 197, 203 (1893).

[22] *U.S.* v. *Kissel*, 218 U.S. 601 (1910).

[23] *Addyston Pipe and Steel Co.* v. *U.S.*, 175 U.S. 211 (1899). The Addyston Pipe case made it clear and unmistakable that the type of competition required by the Sherman Act is *price competition.*

supplies, or limit production is illegal per se under the Sherman Act. It is important to compare the policy of the Court on conspiracies with its policy toward mergers which restrain a substantial volume of trade—even greater than in the Addyston Pipe case (see Chapter 9, pages 179–182).

THE TRENTON POTTERIES CASE

Two additional cases which serve as landmarks in the law on collusive restraints are the Trenton Potteries case (1927) and the Madison Oil case (1940).[24] A brief review of these cases will serve to indicate the unqualified manner in which the Supreme Court condemns conspiracies restricting competition.

The Trenton Potteries case involved the legality of a price-fixing agreement entered into by a group of manufacturers who produced some 82 percent of the vitreous pottery fixtures made in the United States for use in bathrooms and lavatories. The evidence clearly showed the existence of an agreement to fix prices and restrict sales to jobbers, and the defendants did not contest the facts of the case. They did, however, seek to show that their motives were worthy and that their conduct was reasonable. In particular, they claimed that concerted action was necessary in order to eliminate ruinous and chaotic competition. They further maintained that the prices which they had fixed were reasonable, and that no injury to the public could be shown.

In its decision, the Supreme Court stated clearly that it was unwilling to apply the doctrine of reasonableness to price-fixing agreements. The test of illegality, the Court declared, must be judged by the effect of the restraint on competition, for the purpose of the law is to maintain competition in order to protect the public against the evils of monopoly. Since the aim of every price-fixing agreement is an elimination of price competition, the Court concluded that all agreements on price are illegal. In the words of the Court,

> The aim and result of every price-fixing agreement, if effective, is the elimination of one form of competition. The power to fix prices, whether reasonably exercised or not, involves power to control the market and to fix arbitrary and unreasonable prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow. Once established, it may be maintained unchanged because of the absence of competition secured by the agreement for a price reasonable when fixed. Agreements which create such potential power may well be held to be in themselves unreasonable or unlawful restraints, without the necessity of minute inquiry whether a particular price is reasonable or unreasonable as fixed. . . .[25]

[24] *U.S.* v. *Trenton Potteries Co.*, 273 U.S. 392 (1927); and *U.S.* v. *Socony-Vacuum Oil Company*, 310 U.S. 150 (1940).

[25] *U.S.* v. *Trenton Potteries Co.*, 273 U.S. 392, 397 (1927).

TABLE 15. The Ten Leading Antitrust Department of Justice Cases

Cases	Discussion of Cases May Be Found on Text Page
1. *United States* v. *Addyston Pipe & Steel Co.*, 85 Fed. 271 (1898)	162
2. *United States* v. *Aluminum Co. of America*, 148 F. (2d) 416 (1945)	185
3. *American Tobacco Co.* v. *United States*, 328 U.S. 781 (1946)	165
4. *United States* v. *du Pont* (Cellophane), 351 U.S. 377 (1956)	187
5. *Standard Oil Co. of New Jersey* v. *United States*, 221 U.S. 1 (1911)	174
6. *United States* v. *Socony-Vacuum Oil Co., Inc.*, 310 U.S. 150 (1940)	164
7. *United States* v. *Colgate & Co.*, 250 U.S. 300 (1919)	195
8. *Standard Oil Co. of California* v. *United States* (Standard Stations), 337 U.S. 293 (1949)	324
9. *United States* v. *du Pont* (General Motors), 353 U.S. 586 (1957)	192
10. *United States* v. *Paramount Pictures, Inc.*, 334 U.S. 131 (1948)	201

SOURCE. Compiled by Worth Rowley, antitrust attorney, in consultation with the Antitrust Division, Department of Justice. From *Antitrust Bulletin*, November–December 1958, p. 629

THE MADISON OIL CASE

In the Madison Oil case the Court again emphasized that the factor of reasonableness has no application in price-fixing cases. This case involved the legality of a price-stabilization plan devised and managed by the major oil refiners in the Midwestern area who produced some 85 percent of the gasoline sold in that area. During the period of the National Recovery Administration (1933–1935), the defendants worked out a plan for stabilizing prices, and the arrangement was approved by the Administration. After the NRA was held to be unconstitutional, the defendants continued to engage in price-stabilizing activity; and the government thereupon filed a charge of collusive price fixing. The plan of control consisted mainly of concerted action to buy "surplus" or "homeless" gasoline, freely offered by independent refineries, which was not readily salable by them at the prices maintained by the major companies.

The major refiners sought to defend their activity on the ground that concerted action to eliminate an evil—"distress" gasoline—should not be condemned, even though it "would necessarily tend to produce fairer or higher price levels." Justice Douglas, speaking for the Court, replied that the determination of "fairer" prices cannot be left to private control. "The reasonableness of prices," he declared, "has no constancy due to the dynamic

quality of business facts underlying price structures. Those who fixed reasonable prices today would perpetuate unreasonable prices tomorrow, since those prices would not be subject to continuous administrative supervision and readjustment in the light of changed conditions."[26]

THE TOBACCO CASE (1946) AND THE INDICATORS OF MONOPOLY

In the Tobacco case, decided in 1946, the Supreme Court specified two tests to be employed in identifying illegal monopoly power. They are (1) the power to manage prices and (2) the power to exclude competition. This power may be exercised either by a single dominant firm or by several acting as one (unified selling).

The Tobacco case involved the "Big Three"—the American Tobacco Company, Liggett and Myers Tobacco Company, and R. J. Reynolds Tobacco Company. The Department of Justice filed the case in 1940, charging that these firms had conspired, dominated, and controlled the purchase of leaf tobacco and the sale of cigarettes in violation of Sections 1 and 2 of the Sherman Act. At the time the suit was brought the three defendants controlled some 68 percent of the cigarette business and more than 80 percent of the business in their price line. The Tobacco case was a criminal action, and the government sought only to punish the defendants for their past illegal conduct. No affirmative relief was asked.

In the District Court the jury found that the defendants had conspired to restrain commerce in the buying and selling of tobacco in violation of Section 1 of the Sherman Act. Upon the basis of the Court's instruction that monopoly does not require the actual exclusion of competitors from a trade, but only the "power to control and dominate interstate trade," the jury also found that the defendants were guilty of violating Section 2 of the Sherman Act. The Supreme Court affirmed the position taken by the District Court, and fines totaling $255,000 were levied against the defendants. The Tobacco case, it may be noted, involved a "loose-knit" combination and not a merger.

In appealing their case to the Supreme Court, the tobacco companies sought to defend their behavior by declaring that (1) they had not excluded competitors, as was declared to be illegal in the old American Tobacco and Standard Oil cases (1911); (2) they could not be guilty of the crime of monopoly, because there were three separate companies actively competing for business; and (3) there was no direct evidence of an agreement among the three companies on price.

The facts in the Tobacco case indicated that the "Big Three" had maintained a "friendly relationship" and "a community of interest" which enabled them to follow a common course of action on prices. In the purchase

[26] *U.S.* v. *Socony-Vacuum Oil Company,* 310 U.S. 150, 221–222, 225–226 (1940). This case is called the Madison Oil case because the trial was held in Madison, Wisconsin.

of leaf tobacco, it was found that the defendants eliminated competition by buying predetermined percentages of the supplies offered and by scrupulously following a plan of paying the same prices for the same grades of tobacco. Likewise, in the sale of cigarettes the evidence indicated that the three defendants had consistently sold at identical prices and discounts since 1927. There was no direct evidence of formal agreement. The jury, however, made a finding of conspiracy upon the basis of circumstantial evidence, and the Court accepted this conclusion.

The Court commented especially on the large advertising expenditures of the three defendants—over $40,000,000 a year—and the close relationship which existed between these expenditures and the volume of sales. The Court observed that the use of large-scale advertising serves as an effective device for stifling competition. "Such tremendous advertising," the Court declared, "is . . . a widely published warning that these companies possess and know how to use a powerful offensive and defensive weapon against new competition. New competition dare not enter such a field, unless it be well supported by comparable national advertising. . . . Prevention of all potential competition is the natural program for maintaining a monopoly here, rather than any program of actual exclusion."[27]

Upon the basis of the concerted action of the defendant tobacco companies in managing prices and in maintaining a power of control over the activity of independents, the Court found that the "Big Three" were guilty of monopoly. A correct interpretation of the Sherman Act, the Court declared, makes the existence of *the power to manage price or exclude competitors* the controlling test of monopoly. In its words:

> The question squarely presented here . . . is whether actual exclusion of competitors is necessary to the crime of monopolization in these cases under Section 2 of the Sherman Act. We agree with the lower courts that such actual exclusion of competitors is not necessary to that crime in these cases. . . . Neither proof of exertion of the power to exclude nor proof of actual exclusion of existing or potential competitors is essential to sustain a charge of monopolization under the Sherman Act. . . . *The authorities support the view that the material consideration in determining whether a monopoly exists is not that prices are raised and that competition actually is excluded but that power exists to raise prices or to exclude competition when it is desired to do so.*[28]

THE DOCTRINE OF PARALLEL ACTION

Historically, proof of conspiracy has been found in direct evidence of actual "agreement"—i.e., in proof of a meeting of the minds of two or more

[27] *American Tobacco Co.* v. *U.S.*, 328 U.S. 781, 797 (1946).

[28] *Ibid.*, pp. 781, 808–811. Italics supplied. The phrase "power to exclude competition" means the power to determine who enters, or who stays in, the market.

persons to do an illegal act. More recently, however, the courts have been willing to construe or infer agreement from a course of dealing or other circumstances. Business firms today have become highly sophisticated about making collusive restraints, and rarely is direct evidence of agreement available. Consequently, the prosecution has pressed for the use of circumstantial evidence. In the Tobacco case, for example, there was no direct evidence of conspiracy. Nevertheless, the Court of Appeals found the existence of a conspiracy in the business practices of the defendants. In passing upon this case, the Court of Appeals stated:

> Where the circumstances are such as to warrant the jury in finding that the conspirators had some unity of purpose, or some common design or undertaking, or some meeting of minds in an unlawful arrangement, the conclusion that a conspiracy is established, is justified.[29]

It is important to note, however, that under the Sherman Act proof of parallel action alone—such as the quoting of identical bid prices—is not enough to transgress the law. The circumstantial evidence must be sufficient to warrant the finding or inference of *agreement*. Thus the Supreme Court in the Theater Enterprises case (1954) stated with respect to parallel business behavior:

> The crucial question is whether respondents' conduct toward petitioner stemmed from independent decision or from an agreement, tacit or express. To be sure, business behavior is admissible circumstantial evidence from which the fact finder may infer agreement. But this Court has never held that proof of parallel business behavior conclusively establishes agreement or, phrased differently, that such behavior itself constitutes a Sherman Act offense. Circumstantial evidence of consciously parallel behavior may have made heavy inroads into the traditional judicial attitude toward conspiracy; but "conscious parallelism" has not yet read conspiracy out of the Sherman Act entirely.[30]

THE SHERMAN ACT AND OLIGOPOLY

The application of the Sherman Act to several large companies which act as one on price is the weakest aspect of our antitrust law program. Three forms of this type of unified selling may be distinguished. First, there is the situation in which *conspiracy* can be proved by direct or circumstantial evidence. Such a form of concerted action is clearly illegal under the Sherman Act (and also under Section 5 of the Federal Trade Commission Act). The Tobacco decision (1946) is a case in point.

Secondly, there is the situation in which one company is the recognized

[29] *American Tobacco Co.* v. *U. S.*, 147 F. (2d) 93, 107 (1944).

[30] *Theater Enterprises, Inc.* v. *Paramount Film Distributing Corporation*, 346 U.S. 537, 540-541 (1954).

and accepted price leader, and the other companies regularly adopt and observe the prices set by the leader. In order to discipline recalcitrant followers, a price leader often resorts to sporadic price cutting, geographic discrimination, and threats of reprisal. If it can be shown that monopolistic devices have been used to effectuate price leadership, the leader can be prosecuted for its predatory acts.

Thirdly, there is the category in which several companies act as one on price, *allegedly without agreement.* Competitive rivalries may exist in advertising, quality, and service, *but not on price.* Delivered prices are usually quoted according to some formula, and the delivered prices at any destination point are usually identical.

In the United States, it is exceedingly difficult to secure evidence on collusive restraints, for conspiracy on price is illegal, per se. The Antitrust Division observes identical bids and prices in many industries—such as steel and typewriters—but their investigations have not so far developed proof of unlawful agreement. Conspirators have become exceedingly sophisticated in leaving no record of their activities. At the present time, the Antitrust Division (as well as the Federal Trade Commission) is unwilling to prosecute oligopoly (and identical pricing) in the absence of actual evidence of agreement (conspiracy). The basis for this position is the Theater Enterprises case (1954) discussed above.

TRADE ASSOCIATIONS AND THE LAW ON CONSPIRACY

A trade association may be defined as a voluntary association of business competitors, usually in one line of business activity, for the purpose of promoting their line of business by cooperative activities of one sort or another. Legitimate kinds of trade association activity consist of sales promotion work, public relations, standardization of products, technical research, collection of statistics, formulation of just and equitable trade practices, and reporting of prices at which goods in the past have actually been sold. Illegal activity, on the other hand, consists of collusive price fixing; the use of price-reporting systems which serve to restrict price competition; the use of boycotts, black lists, "peaceful persuasion," or other forms of coercion to injure suppliers, competitors, or customers; and collective activity to keep newcomers from the field (see Table 16).

Since the common interest of all trade members centers on the prices received for their products, most trade associations engage in collecting and disseminating statistics and price information. The adoption of this activity by trade associations was actively sponsored during the period 1912–1920 by Mr. Arthur Jerome Eddy, a successful lawyer and author of a book entitled *The New Competition* (1912). In accordance with the "Eddy plan," trade association members report price data to an association which, in turn, makes

TABLE 16. Cooperation Between Firms in the Same Business as Regulated by Decisions Under the Sherman Act

What Trade Associations May Not Do

1. Fix or enhance prices.
2. Limit the quantity or quality of production.
3. Allocate customers or divide markets.
4. Restrict channels or methods of distribution.
5. Restrict entry into a line of business.

What Trade Associations May Do

1. Collect and disseminate statistics.
2. Define product standards.
3. Exchange credit information.
4. Define trade terms.
5. Cooperate in research and development.

the information available to all members. Such associations are known as "open-price associations."[31] In practice, open-price associations may be "open" only in a partial sense, for frequently they are unwilling to furnish price data and trade statistics to buyers or to the general public.

MAIN REASON FOR TRADE ASSOCIATION MOVEMENT

The ideas of Mr. Eddy went further than that of creating associations to provide for price publicity; and in the full utilization of his "plan," Mr. Eddy believed that businessmen should engage in "cooperation" rather than in competition. This proposal proved to be very attractive to many businessmen, and trade associations have been formed in virtually every line of business activity—from local associations of retail merchants to national associations of manufacturers of the basic commodities. Mr. Eddy's book *The New Competition*, moreover, continues to be widely read. Many businessmen and lawyers look upon it as being the best available exposition of the value of trade associations to "stabilize" business and to produce "fairer" price levels.

In each industry which has been studied by the British Monopolies Commission, it has been found that the principal instrument for restrictive prac-

[31] The Federal Trade Commission defines an open-price association as one "distributing or exchanging price information." In view of the Commission, "The distinctive activity in question is the circulation of price information as a part of the association work. The prices referred to are sales prices of commodities dealt in by association numbers. The word 'exchanging' is interpreted to mean that members systematically furnish information with respect to prices for the use of other members" (*Open-Price Trade Associations*, letter from the Chairman of the Federal Trade Commission, 70th Congress, second session, Senate Document 226, February 11, 1929, p. 36).

tices was a trade association. Likewise, in the United States, studies of collusion, price leadership, basing-point systems, and the like, have revealed the important role played by trade associations in promoting unity of action. In their analysis of trade associations, Professors Stocking and Watkins conclude that "the trade association movement represents an organized effort to moderate the rigors of competition. It reflects a lack of confidence in genuinely free enterprise, a fear of the destructive consequences of uninhibited price warfare. . . . Trade associations promulgate a gospel of live and let live."[32]

OPEN-PRICE ASSOCIATIONS CONDEMNED

The legality of open-price associations was first considered by the Supreme Court in the Hardwood Lumber Association case (1921). There was general agreement on the facts in this case, the Court stated, and the legal issue was essentially whether or not the open-price plan is likely to result in an elimination of price competition. A majority of the Court found that the "close cooperation" provided for in the "plan" in filing actual prices and asking prices was plainly inconsistent with the Sherman Act. In the words of the Court:

> Genuine competitors do not make daily, weekly, and monthly reports of the minutest details of their business to their rivals, as the defendants did . . . and they do not submit the details of their business to the analysis of an expert, jointly employed, and obtain from him a "harmonized" estimate of the market as it is and as, in his specially and confidentially informed judgment, it promises to be. This is not the conduct of competitors but . . . clearly that of men united in an agreement, express or implied, to act together and pursue a common purpose under a common guide. . . . The "Plan" is, essentially, simply an expansion of the gentlemen's agreement of former days, skillfully devised to evade the law. . . . The fundamental purpose of the "Plan" was to procure "harmonious" individual action . . . concerted action . . . tacit understanding that all were to act together. . . .[33]

The general condemnation of open-price plans was again confirmed by the Supreme Court in the Linseed Oil Association case (1923).[34] The price plan in this case provided for the filing of actual prices and quoted prices, and members agreed not to deviate from the filed prices without prior notice. The prices collected by the association, moreover, were not available to purchasers or to the public. In a unanimous decision the Court found that the manifest purpose of the plan was to defeat the Sherman Act.

[32] George W. Stocking and Myron W. Watkins, *Monopoly and Free Enterprise* (New York, 1951), p. 234.

[33] *American Column and Lbr. Co.* v. *U.S.*, 257 U.S. 377, 410–411 (1921).

[34] *U.S.* v. *American Linseed Oil Co.*, 262 U.S. 371 (1923).

FINAL ACCEPTANCE OF OPEN-PRICE ASSOCIATIONS BY THE SUPREME COURT

Subsequently, in the Maple Flooring and Cement Association cases (1925), a majority of the Court held that the open-price plan in principle is a desirable and beneficial form of trade activity.[35] How is this change in the attitude of the Court to be explained? In retrospect, it appears that the vacillating policy of the Court with respect to open-price associations may be explained by (1) the belief of a minority of the Court, and then a majority, that price reporting activities in principle have merit in providing market information; (2) the fact that in the Maple Flooring and Cement cases the government failed to prove that the price-reporting programs had objectionable effects; and (3) by the fact that in each of the four cases under consideration the Court did not have all the relevant material presented to it.

Price publicity is an essential condition of market activity; and in the absence of governmental intervention to perform this service, it is understandable that private groups will undertake to meet the need. The majority of the Supreme Court in the Maple Flooring and Cement cases, probably with this thought in mind, appears to have been willing to sanction open-price associations in the absence of a showing of restrictive effects upon price competition. Thus, Justice Stone in the Maple Flooring decision carefully stated: "We decide only that trade associations . . . which openly and fairly gather and disseminate information . . . as did these defendants . . . without, however, reaching or attempting to reach any agreement or any concerted action with respect to prices or production or restraining competition, do not thereby engage in unlawful restraint of commerce."[36]

SOME CONCLUSIONS ON THE LEGALITY OF OPEN-PRICE PLANS

What conclusions can be drawn with respect to the legitimate activity of open-price association?

First, it may be said that there is general agreement that in so far as a trade association collects *impersonal* statistics with respect to actual prices on closed transactions, production, inventories, and sales, the service is a desirable one which is promotive of competition.

Secondly, any plan for the collection and dissemination of information concerning prices, output, and related matters in any industry, is unlawful

[35] *Maple Flooring Manufacturers' Association* v. *U.S.*, 268 U.S 563 (1925); and *Cement Manufacturers' Protective Association* v. *U.S.*, 268 U.S. 606 (1925). See also C. D. Edwards, *Maintaining Competition* (New York, 1949), pp. 43-45.

[36] 268 U.S. 563, 586 (1925).

if it has resulted, or is likely to result, in the elimination of price competition, or if it can be said to constitute an agreement to fix prices or limit production.

Thirdly, generally accepted legal opinion is that the prices reported must be made available to buyers and sellers alike. In the injunction issued by the Court in the Sugar Institute case (1936), for example, it was provided that members are restrained from collecting prices if said information is not "fully and fairly" made available to the buyers and distributors of sugar.

TRADE ASSOCIATIONS PERMITTED TO COLLECT AND DISSEMINATE PERSONAL SALES DATA

A controversial question is whether a trade association should be permitted to collect and disseminate personal and intimate data on prices and sales, such as list prices for future sales, the purchases and sales of particular persons, and the actual prices received and paid by designated persons. Experience has shown that in so far as trade members report and collect personal data, the practice is likely to result in coercion and trade restraints. Dominant trade members are in a position to exert pressure on weaker sellers to bring list prices up to a common level. Large sellers, in securing information on the sales or purchases of particular companies, moreover, are able to watch their percentage of the business in a plan of "sharing the market."

The public exchanges—such as the security and commodity exchanges—disseminate prices on actual, *closed* transactions. No names, either of buyers or sellers, are made available. Bid and ask prices, moreover, are reported without the names of prospective buyers or sellers. It is this kind of market information which unquestionably facilitates the operation of price competition without leading to restraints or coercion.

The Tag Institute case (1949) is significant because it indicates the acceptance of an open-price association which collects and disseminates (1) the list or asking prices of members identified by name of member; (2) data on all "off-list" transactions showing name of seller, description of product, quantity, list price, actual list price, and the state in which the buyer resided; and (3) summary data compiled from the invoice sheets on quantities sold and total sales receipts.

The Federal Trade Commission in 1941 charged that the personal data plan of the Tag Institute was being used to restrain price competition. In 1947 a cease-and-desist order was issued. The Tag Institute carried the order to the Court of Appeals, and the court ruled against the Commission. In the view of the court, "Nor is there evidence of 'retaliatory action' by any subscribers to coerce other subscribers into adherence to list prices."[37] Subsequently, the Solicitor General declined to appeal the case to the Supreme Court.

[37] *Tag Manufacturers Institute* v. *FTC*, 174 F. 2d 452, 459 (1949).

THE PROVISION OF PRICE PUBLICITY AS A PUBLIC FUNCTION

The principle that trade members in open competition need and should have price publicity is sound, for they cannot compete effectively without a knowledge of past prices and statistics on demand and supply. Buyers want to know whether or not they are paying a price which is currently in line, and sellers wonder if they are being deceived by unverified reports of price reductions. Price publicity, experience has shown, is essential to effective competition in open markets.

In order to supply buyers and sellers of the principal agricultural and fishery products with reliable price information, the federal government maintains an extensive price-reporting service. The daily reports issued on shipments, supplies, and prices on actual transactions, moreover, have proved to be very useful (see Chapter 4, pages 62–63, and Chapter 11, pages 250–251).

By way of contrast, the record of trade associations in providing price publicity is not a good one. In many cases, price data are issued only to members; and when they are made available to buyers, there is always a question about their reliability, for it is the sellers who are doing the reporting. When sellers are few, moreover, they tend to act mutually in avoiding competition, and the provision of intimate details on prices, costs, and sales greatly facilitates concerted action.

In order to (1) provide reliable market information to all interested parties and (2) discourage and minimize the use of trade data for price-fixing purposes, it has frequently been suggested that the reporting of industrial prices and trade statistics should be handled either by some quasi-public organization, such as a commodity exchange, or by the government itself.

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9

The Sherman Act and Mergers

MERGERS AND MONOPOLY

Statement of Present Rule of Law

Under the Sherman Act, as construed by the Supreme Court, a merger is not illegal, per se, but only (1) when there is an overwhelming percentage control of an industry or (2) when there are "unworthy motives" or predatory acts.

Section 2 of the Sherman Act, we have seen, condemns (1) monopolization, (2) attempts to monopolize, and (3) conspiracies to monopolize *any part* of trade or commerce in or affecting interstate commerce. In general, the great monopoly cases have been brought against a *single* enterprise which has become large (and monopolistic) through a fusion of formerly independent business units. When a case is brought against a dominant enterprise, the government usually charges violation of Section 2 of the Sherman Act.

In applying Section 2, the courts have not used a clear legal definition of monopoly based upon an economic conception. Generally, they have centered their attention on predatory acts, exclusion of competitors, conspiracies to monopolize, and the impact of mergers on the market setting—i.e., whether or not some competitors still remain. For the most part, the courts have been unwilling to jeopardize business interests by ordering a dissolution of mergers which, in fact, restrain competition among many formerly independent plants.

THE USE OF THE SHERMAN ACT TO DISSOLVE MONOPOLISTIC MERGERS

In 1911, the Supreme Court handed down decisions under the Sherman Act against two of the largest industrial combinations in the country—the Standard Oil Company and the American Tobacco Company.

The Standard Oil Company was organized in New Jersey in 1899 to hold the stock of some seventy different corporations engaged in operating oil refineries, oil wells, pipelines, storage plants, and distribution facilities. It is reported that the various plants of the company produced over 200 by-products. Most of the facilities had formerly been united under a central control by means of the trust device. As early as 1882 the trust had secured a control of about 90 percent of the oil-refining business, and this percentage control was maintained in the new organization.

The American Tobacco Company was likewise a New Jersey corporation, originally incorporated in 1890. By pursuing a relentless policy of cutthroat competition, the company was able to induce independents to sell out their stock or assets, and an ownership control was rapidly secured over a large part of the tobacco industry. At the time of the suit, it was estimated that the corporation had acquired a control over some 95 percent of the cigarette business, 85 percent of plug tobacco production, 75 percent of smoking tobacco manufacture, and 80 percent of the snuff production. In both the Standard Oil and the American Tobacco cases the government asked for a dissolution of the monopolistic mergers.

The records in the Standard Oil and American Tobacco cases were replete with examples of predatory practices employed by the combinations to injure, eliminate, or buy up competitors in order to secure monopoly control. Specifically, it was found that the Standard Oil Company had (1) secured rebates and other discriminatory favors from the railroads, (2) pursued a policy of cutting prices in particular areas while maintaining or increasing them in localities in which it had no competition, (3) bribed railway and other employees for information on competitors, (4) established bogus companies to sell petroleum products at "cut" prices, (5) controlled pipelines to the disadvantage of competitors, and (6) allocated sales areas for its subsidiaries so as to eliminate competition among them.

Similarly, in the American Tobacco case, it was found by the Court that the large financial power of the company was used (1) to cut prices in one area while maintaining them elsewhere in order to drive out competitors or compel them to join the combination; (2) to buy up a control over all the elements necessary for manufacturing tobacco products, so as to exclude others from the trade; (3) to spend "millions upon millions of dollars in buying out plants . . . to close them up and render them useless for the purposes of trade"; and (4) to require vendors, stockholders, and employees "to bind themselves, generally for long periods, not to compete in the future."

After surveying the "undisputed" evidence in the Standard Oil and American Tobacco cases, the Court held that the "acts," "purposes," and "motives" of the giant combinations showed conclusively that it was the plain duty of the Court to apply the Sherman Act and order a dissolution of the combinations. Thus, in the American Tobacco case, the Court declared that "the history of the combination is so . . . demonstrative of the existence from

the beginning of a *purpose* to acquire dominion and control of the tobacco trade, not by the mere exertion of the ordinary right to contract and to trade, but by methods devised in order to monopolize the trade by driving competitors out of business, which were ruthlessly carried out upon the assumption that to work upon the fears or play upon the cupidity of competitors would make success possible."[1]

In the Standard Oil decision, the decree "commanded the dissolution of the combination, and . . . directed the transfer by the New Jersey corporation back to the stockholders . . . of the stock which had been turned over to the New Jersey company in exchange for its stock." Since a few closely associated capitalists owned most of the stock in the holding company, this decree resulted in giving the same persons a controlling interest in the subsidiary corporations. Instead of owning a controlling interest in a single company, they now owned a controlling interest in many companies. No attempt was made to require these men to divest themselves of their controlling interest in one or more of the various corporations by requiring a public sale of the stock.

In 1915 the United States Commissioner of Corporations reported: "The general opinion is that this dissolution is effective neither in theory nor in fact. There is much ground for believing that it did not result in independent action or active competition between the various subsidiary companies. . . . That the dissolution of the Standard Oil Company was not more satisfactory in form and results appears to be due, however, to the manner of its accomplishment rather than to any inherent difficulty in reestablishing competitive conditions among the component parts of the combination."[2]

A special study of the petroleum industry made in 1948 points out that the effect of the dissolution "was to divide the Standard Oil Company into a series of companies, each of which was supreme in a particular geographical area." Nothing was done by the Court to create competition *within* a geographical sales area. Instead, within each sales territory, the study continues, each Standard Oil Company has "provided the necessary strength and machinery for price leadership and policy leadership of all kinds."[3]

The American Tobacco Company had secured its position of domination by the acquisition of assets as well as stock; and in providing for its dissolution, the Court approved a plan by which the factories, warehouses, brands, and other assets owned by the company were assigned to three large "full line" companies and some eleven small ones. Since the group of persons who controlled the American Tobacco Company secured large blocks of stock in these corporations, this decree of dissolution, it is generally agreed, was likewise one of form rather than of substance.

[1] *U.S.* v. *American Tobacco Co.*, 221 U.S. 106, 181–182 (1911).

[2] Joseph E. Davies, *Trust Laws and Unfair Competition* (Washington, 1915), p. 18.

[3] Eugene V. Rostow, *A National Policy for the Oil Industry* (New Haven, 1948), pp. 6–7.

THE DEVELOPMENT OF THE "RULE OF REASON" IN THE STANDARD OIL AND AMERICAN TOBACCO CASES

Although the Sherman Act prohibits "every contract, combination in the form of trust or otherwise, or conspiracy," as well as "monopolization," the Court did not accept this language. Instead, it centered its attention on a consideration of whether or not there was an "intent" or "purpose" to monopolize an industry. In the Standard Oil and American Tobacco cases, the Court happened to find an illegal intent, but it gave no clear-cut guide in its decisions for future public policy. How about the legal status of mergers, as such? How about discriminatory prices made by a combination to enhance its profits in certain areas and to match or undercut prices in other areas? The Court gave no legal or economic analysis of these aspects of business behavior. Its view, in effect, appeared to be that anything is fair as long as it does not manifest an *intent* or *purpose* to monopolize an industry.

Indeed, in the absence of predatory acts, the Court appeared to be willing to accept mergers and such price policies as the giant corporations might pursue. In the American Tobacco case, in particular, it stated that the combination was illegal "not because of the vast amount of property aggregated by the combination, not because, alone, of the many corporations which the proof shows were united by resort to one device or another. Again, not alone because of the dominion and control over the tobacco trade which actually exists." This sympathetic analysis and point of view of the Court toward mergers laid the groundwork for the development of the so-called "abuse theory" of mergers (or of monopoly).

In an explanation of its action in not condemning the giant mergers in the oil and tobacco industries, as such, the Court developed the so-called "rule of reason." According to Chief Justice White, speaking for the Court, since the Sherman Act does not specifically define acts which are in restraint of trade, the Court itself must in every case decide whether or not the particular acts have this effect. In exercising this judgment, he stated in the Standard Oil case, the Court must be guided by a "rule of reason."

THE RULE OF REASON

In essence, the "rule of reason" means that a court, in applying a statute condemning restraints on trade, applies it not in a rigid "thou-shalt-not" fashion, as written, but rather with the "flexibility of discretion." It means that a court applies an antitrust statute by (1) considering the impact of the particular situation under examination (i.e., a merger) on the particular market setting (whether *some* competition still flourishes); and (2) looking at the particular situation under examination in the light of a factual showing of illegality (whether there are predatory acts or illegal motives).

The rule of reason applied to mergers means that the acquisition of competitors may be excused by the Court if it finds that the restraint is not "total" or "unreasonable"—that is, if (1) the restraint does not extend to *all* plants in a given line of industry (*some* competition still remains) or (2) the large, acquiring company has not engaged in specific evils. The rule makes possible the acceptance of a degree of monopoly which, in the eyes of the judges, is tolerable.

It has been urged by attorneys in various antitrust cases that the rule of reason should also be applied to price-fixing agreements and to tying restrictions. Thus far, however, the rule has been applied only to mergers.

The rule of reason announced by Chief Justice White in the Oil and Tobacco cases had been urged by defendants in two earlier cases, but was rejected by the Court, with Justice White dissenting, *U.S.* v. *Trans-Missouri Freight Assn.*, 166 U.S. 290 (1897), and *U.S.* v. *Joint Traffic Assn.*, 171 U.S. 505 (1898). In these cases, the Court declared that the Sherman Act condemns "*every* contract, combination . . . or conspiracy in restraint of trade or commerce." To prohibit only "unreasonable" restraints of trade, it stated, would be to engage in "judicial legislation." Subsequently, in 1911, with changes in the personnel of the Court, Justice White found support for his view and wrote the majority opinion.

Rule of Reason Makes for Indefiniteness in the Regulation of Commerce

Following the decisions of 1897 and 1898 rejecting the proposal to add a rule of reason to the Sherman Act, various business leaders appealed to Congress to modify the law on the ground that the decisions were hurting the "business interests" of the country. Bills were introduced in Congress to change the Act, but they were not adopted. The general view of Congress was expressed in 1909 in a report by the Senate Judiciary Committee which declared:

> The antitrust act makes it a criminal offense to violate the law, and provides a punishment both by fine and imprisonment. To inject into the act the question of whether an agreement or combination is reasonable or unreasonable would render the act as a criminal or penal statute indefinite and uncertain, and hence, to that extent, utterly nugatory and void, and would practically amount to a repeal of that part of the act. Justice Brewer, in the case of Tozer v. U.S. (52 Fed., 917), makes this perfectly clear and plain. . . . "But, in order to constitute a crime, the act must be one which the party is able to know in advance whether it is criminal or not. The criminality of an act cannot depend upon whether a jury may think it reasonable or unreasonable. There must be some definiteness and certainty."[4]

[4] Committee on the Judiciary, United States Senate, 60th Congress, second session, Senate Report 848, 1909, pp. 10-11.

The insight which Congress had in 1909, it is believed by many, has been fully vindicated by time. The Sherman Act, *as interpreted by the Supreme Court,* has not checked the growth of economic concentration. Its application, moreover, has given rise to great uncertainty on what the law means and what it condemns. Businessmen today seek, but do not find, a clear-cut answer to questions on which trade restraints are illegal.

THE UNITED STATES STEEL CORPORATION AND THE RESTRICTION OF COMPETITION IN THE STEEL INDUSTRY

In 1920 the Supreme Court was given a significant opportunity to use its "rule of reason" in a case involving the largest industrial combination ever formed. The United States Steel Corporation, organized in New Jersey in the early months of 1901, was a "combination of combinations." It brought together in one financial unit a control over a series of corporations which had already secured control over the principal plants in their respective lines of business in the steel industry. The underlying mergers had largely been formed not only to secure a combination of like plants in a given field—such as tin-plate mills, wire mills, or pipe and tube mills—but also to secure a control over raw materials and production facilities from the ore to the finished products. Mergers of like plants—such as the American Tin Plate Company, which secured a control of 95 percent of the tin-plate production in the country—were admittedly formed to restrict and control competition among the constituent units, and in adding iron ore mines, pig iron mills, and fabricating facilities the horizontal mergers sought to make certain that they would have ready supplies or ready outlets without price dictation by other monopoly groups. The principal combinations which the United States Steel Corporation acquired with its formation in 1901 were the following:

Carnegie Steel Company, 1900 (20 plants).
Federal Steel Company, 1898 (20 plants).
American Steel and Wire Company, 1899 (39 plants).
National Tube Company, 1899 (15 plants).
American Bridge Company, 1900 (26 plants).
National Steel Company, 1899 (10 plants).
American Tin Plate Company, 1898 (265 plants).
American Sheet Steel Company, 1900 (26 plants).
American Steel Hoop Company, 1899 (14 plants).

The acquisition of the foregoing combinations, together with additional iron ore and coal property, transportation lines, and other facilities, gave the corporation a control over 65 to 75 percent of all lines of steel manufacturing

and some 80 percent of the best iron ore reserves in the country.[5] Vertical integration had largely been accomplished by the constituent companies during the period 1880 to 1900. The corporation itself brought together major companies which were themselves engaged in competition with one another.

THE ACCEPTANCE OF GIANT MERGERS BY THE COURTS

The Department of Justice brought action against the United States Steel Corporation in 1912. The decision of the lower court was rendered in 1915 and that of the Supreme Court in 1920. The Supreme Court upheld the lower court in a four-to-three decision and refused to order a dissolution of the corporation. According to the Supreme Court, the corporation, which at the time of the suit produced about 50 percent of all steel products, was not a monopoly. The testimony presented in the case, the Court stated, did "not show that the corporation, in and of itself, ever possessed or exerted sufficient power when acting alone to control prices of the products of the industry."[6]

For many years, the record indicated, the corporation had used its economic power in trade meetings—the so-called "Gary dinners"—to unite competitors in a policy of unified action on price. Its prices at Pittsburgh became the "official" prices for all iron and steel products, and any changes announced by the corporation were (with rare exceptions) promptly adopted by other steel companies. Some nine months before the government announced its suit the dinner meetings were discontinued. The fact that the corporation had secured the cooperation of its competitors in its plan of controlling price led the majority of the Court to believe that the corporation, in itself, was not a monopoly. Moreover, since the corporation apparently was no longer meeting with its competitors, the Court held that there was an absence of "unworthy motives." In the view of the majority, "whatever there was of evil effect was discontinued before this suit was brought, and this, we think, determines the decree."

The government's presentation of evidence in the Steel case failed to develop the fact that the concerted action among the steel mills centered on the use and maintenance of the basing-point plan of delivered prices under the leadership of the United States Steel Corporation. At the very time the case was being tried this pricing plan was being effectively maintained by the corporation even though the Gary dinners were discontinued. It remained for the Federal Trade Commission to find and condemn (in 1924) the basing-point formula for quoting identical delivered prices (see also Chapter 15).

[5] Report of the Industrial Commission, *Trusts and Industrial Combinations* (Washington, 1901), Vol. 13, pp. 450, 455.

[6] *U.S.* v. *U.S. Steel Corporation*, 251 U.S. 417 (1920).

THE ABUSE THEORY OF MERGERS

In the Steel case, the majority of the court applied the rule of reason to mergers by considering (1) the impact of the merger on the market setting and (2) the existence of acts of illegality. The majority found that there was not overwhelming control—some independents remained—and that the price-fixing dinners had been discontinued. Their decision gave expression to the so-called "abuse theory of mergers"—the Sherman Act test for mergers. This standard declares that in the absence of (1) "unworthy motives" or "predatory acts" or (2) an overwhelming percentage control of an industry, the Court will not dissolve giant mergers. The Court declined to hold that "every contract, combination in the form of trust or otherwise" is illegal on the ground that "it [the Court] is not expected to enforce abstractions" and that it should have "flexibility of discretion." In support of this construction, Justice McKenna declared: "The law does not make mere size [in the form of combinations] an offense. It, we repeat, requires overt acts, and trusts to its prohibition of them and its power to repress or punish them."

The view toward mergers adopted by the Court in the Steel case was reaffirmed in 1927 in the International Harvester case.[7] The International Harvester Company controlled some 64 percent of the output of harvesting machinery and was generally recognized in the industry as being the "price leader" which others followed. The Court, however, refused to order a dissolution of this industrial giant on the ground that "the law . . . does not make the mere size of a corporation, however impressive, or the existence of unexerted power on its part, an offense, when unaccompanied by unlawful conduct in the exercise of its power." As in the Steel case, the Court in declaring this rule of law saw no restraint whatever to legitimate price competition in the combination of scores of former independents into a single financial and price-controlling unit.

In its case against the International Harvester Company, the government presented evidence showing that the company established or made the prices which were regularly followed by others in the industry. It also tried to use this evidence to prove the existence of monopoly in accordance with the economic conception of monopoly. The Supreme Court, however, refused to draw the inference of monopoly. "The fact," the Court stated, "that competitors may see proper, in the exercise of their own judgment, to follow the prices of another manufacturer, does not establish any suppression of competition or show any sinister domination."

Since the Court had accepted the idea of financial bigness—in the absence of a showing of predatory practices—it followed logically that it also had to accept control of price by a dominating seller as a necessary consequence. The only way to eliminate price leadership in such cases would be to dissolve the dominating combination which controls such a large part of the

[7] *U.S. v. International Harvester Company*, 274 U.S. 693 (1927).

supply that it can exercise a considerable degree of monopoly power. This the Court was unwilling to do.

Large combinations secure compliance with their "official" prices by using coercive pressures in the form of discriminatory prices or by offering rewards in the form of higher prices. The principal fear of "retaliation" which makes for unity of action is a fear of *discriminatory* pricing. As Professor Edward H. Levi has observed, "The truth is, of course, that in most monopoly cases, if the court has a mind to do so, it can find abuses."[8]

SOME ECONOMIC ERRORS IN THE VIEW THAT "MERE SIZE" IS NO OFFENSE

Many economists and legal authorities believe that in developing and applying the rule that "mere size" is no offense the Supreme Court has failed to give sufficient attention to the economic and social aspects of financial bigness. In their opinion, there are three significant errors in the position taken by the Court. First, it is pointed out that large financial size is an offense against the public if it means the restraint of competition among many formerly independent and competing firms. The acquisition of the stock or assets of former competitors gives a single price-controlling unit a more complete control over their prices than the most elaborate forms of conspiracy. Since conspiracy on price has long been held to be illegal, it follows *in principle* that an elimination of competition by an acquisition of stock or assets is likewise repugnant to the tenets of the Sherman Act.

Secondly, the view that "mere size" is no offense is based upon the erroneous belief that large combinations are justified because they bring the "economies of mass production." In the Steel case in particular, the majority of the Court was greatly impressed with the idea that there are significant economies of production in large combinations. Actually, the economies of mass production apply to a single plant; and all that a combination of scores of geographically separate plants can do is to seek to maintain technical economy in the individual plants acquired. In the hearings of the Industrial Commission in 1900 on the "advantages" of mergers, Mr. William E. Reis, president of the National Steel Company, a combination of ten large steel plants and extensive coal and ore properties, was asked the following question: "Is there any saving that comes in the manufacture itself, the process of manufacture, that you get through consolidation?" Mr. Reis replied: "I think not."[9] There obviously are advantages in horizontal combinations, for otherwise they would not be formed. These advantages, however, are largely to be found in the control over the price policies of formerly competing

[8] Edward H. Levi, "The Antitrust Laws and Monopoly," *University of Chicago Law Review*, February 1947, p. 158.

[9] Report of the Industrial Commission, *Testimony* (Washington, 1900), Vol. 1, Part 2, p. 947.

plants which a merger gives, rather than in the economics of mass production which apply to the individual plants.

Thirdly, experience has shown that an attack on abuses alone—rather than financial size—frequently does not remedy the problem of monopoly or create the essential conditions for competition. If a given monopolistic device is curbed, it is likely that a dominant firm will be able to develop new ones. The decrees against basing-point pricing in steel and cement, for example, have not stopped the use of delivered pricing systems. Similarly, when firms have attained dominant positions in their fields—as in steel and in the nonferrous metals—they are usually able to exercise "price leadership" without resorting to the crude practices of the early trust period. Their counsel to smaller competitors is "Be Good and You'll Be Happy." As Professor Walter Adams has said, "Once a firm has attained a dominant position in the market place, it no longer has to engage in predatory practices to achieve its monopolistic ends. Its mere existence will be sufficient warning to smaller rivals that noncooperation may be equivalent to suicide."[10]

THE DIVERGENCE BETWEEN THE ECONOMIC AND LEGAL CONCEPTS OF MONOPOLY

In developing and applying the law against monopoly, we have seen, the Supreme Court has directed its attention largely to (1) a condemnation of the ungentlemanly conduct and unworthy motives of mergers; and (2) a prohibition of direct agreements among competitors fixing prices, restricting production, and dividing sales areas.

In its consideration of mergers—notably in the Steel and International Harvester cases—the Court has not seen any restriction whatever to legitimate price competition in the combination of scores of former independents into a single price-controlling unit. As long as a merger does not acquire an overwhelming percentage of the separate plants in the nation, and does not engage in predatory practices, it has been permitted to manage the price policies of its constituent parts with impunity.

The Supreme Court has clearly recognized the existence of monopoly in the collective action (conspiracy) of numerous independent firms on price. In the National Cotton Oil case, for example, the Court defined monopoly as "unified tactics with regard to prices."[11] When the same result is secured by the *acquisition* of scores of competitors, however, the Court has failed to see the presence of monopoly. This legal "blind spot" has possibly been due in part to the judicial practice of thinking of monopoly in an absolute sense—as applying to an entire nation.

The legal view that a control of 50 or 64 percent of the *national* produc-

[10] Walter Adams, "'The Rule of Reason': Workable Competition or Workable Monopoly," *Yale Law Journal*, January 1954, pp. 366–367.

[11] *National Cotton Oil Co.* v. *Texas*, 197 U.S. 115, 129 (1905).

The test of monopoly, he emphasized, is that size which gives a concern power to fix or manage prices.

What percentage of control of production or sales in a nation is necessary to constitute monopoly? Judge Hand wrestled with this question, but gave no clear-cut answer. Percentage figures are useful, but they should be considered in light of the principle that "monopoly is relative to place and limited by distance." Important questions are (1) the percentage of production or sales of a concern *in its area of practical shipment* and (2) whether the firm is able to exercise discretionary control over price in its natural sales territory.

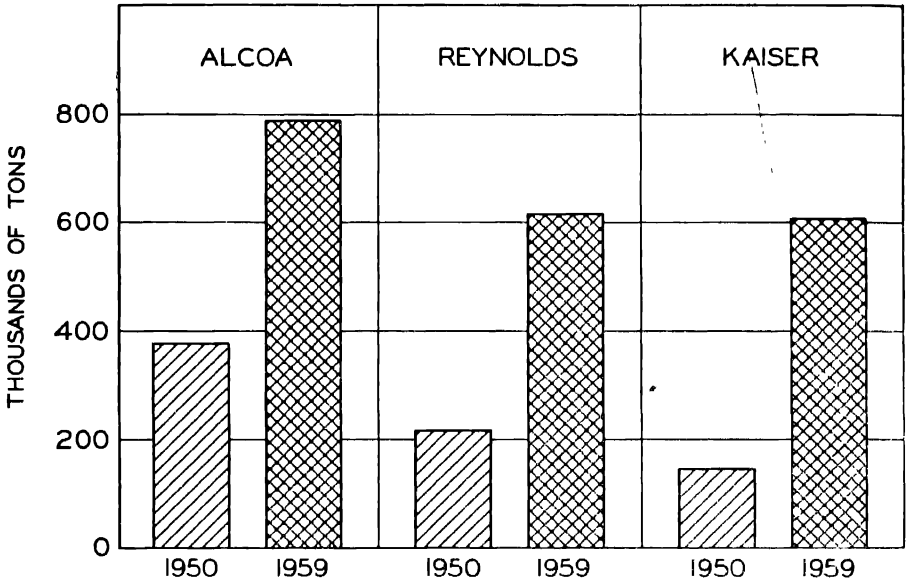

FIGURE 20. Primary Aluminum Capacity, 1950 and 1959. (Source of data: *American Metal Market*)

The Alcoa case was remanded to a District Court for the formulation of relief to be granted the government. Following the disposal of the government's wartime plants to Reynolds and Kaiser, Alcoa in 1947 petitioned the court for a decree (1) that the company had ceased to be a monopoly and (2) that effective competition prevailed. The government, however, denied these allegations and asked the court to carve from Alcoa's facilities a new competitor and to provide other relief. Judge Knox refused to create a new company from Alcoa's physical resources, largely on the ground that Alcoa had strong competitors and also that a strong company, itself, was vital for national security. However, he did require the common control of Alcoa and Aluminum Limited (Canada) to be eliminated.[13]

[13] *U.S.* v. *Aluminum Co. of America,* 91 F. Supp. 333 (1950).

SUPREME COURT TEMPERS RULE ON MONOPOLY POWER

The advanced step taken in the Alcoa case (1945), declaring that monopoly power consists of the power to control prices or exclude competition, was tempered by the Supreme Court in the Columbia Steel case, decided in 1948. The United States Steel Corporation had long been recognized as the price leader—the dominant firm which has the power to fix the price largely observed in the industry. Price leadership is an indication that control over price exists. In the Columbia Steel case, however, the Court permitted the United States Steel Corporation (through its subsidiary Columbia Steel) to acquire an important competitor on the ground that the acquisition did not impose "unreasonable restraint." In so doing, the Court indicated that it still adheres to the "rule of reason"—the Sherman Act test—on mergers.

The Consolidated Steel Corporation was the largest independent steel fabricator on the West Coast, with plants in California, Texas, and Arizona. The government charged (1) that the acquisition of this important fabricator by the United States Steel Corporation would exclude other suppliers from placing orders with Consolidated Steel, since this fabricator would subsequently be supplied by the Geneva, Utah, plant of United States Steel; and (2) that the acquisition would eliminate competition between Consolidated Steel and the subsidiaries of United States Steel in the manufacture and sale of structural steel, pipe, and other fabricated steel products.

In a decision sharply criticized by four dissenting justices, the majority of the Supreme Court gave approval to the acquisition planned by the United States Steel Corporation on the ground that the restraint on competition resulting from such a merger would not be "unreasonable." Justice Reed, speaking for the majority, stated that the test of legality for vertical and horizontal mergers is the same—namely, whether or not they involve "unreasonable restraint." Although recognizing that a restriction on competition was involved in the instant case, the majority held that in its judgment the restraint was not an unreasonable one. How much of a restraint there must be to constitute illegality, the Court did not say. "We do not undertake to prescribe," the majority declared, "any set of percentage figures by which to measure the reasonableness of a corporation's enlargement of its activities by the purchase of the assets of a competitor."[14]

THE CELLOPHANE DECISION (1956) AND POWER OVER PRICE

The Alcoa case (1945) and the Tobacco case (1946) established the rule that monopoly power to be condemned by the Sherman Act is the power to fix prices or exclude competitors. In applying this rule against price leaders

[14] *U.S.* v. *Columbia Steel Co.*, 334 U.S. 495 (1948).

(firms exercising control over price), however, the courts have accepted numerous defenses—such as the strength of competitors and the needs of national defense—second Alcoa decision (1950), the relative share of the market—Columbia Steel case (1948), and the presence of substitute products—the Cellophane case (1956). *Upon the basis of these defenses, the courts, in practice, have been unwilling to condemn the power to manage price as it is in fact exercised in various industry situations.*

In the Cellophane case (1956), the government charged E. I. du Pont de Nemours with monopolizing commerce in cellophane in violation of Section 2 of the Sherman Act. At the time of the action, du Pont produced almost 75 percent of the cellophane sold in the United States. The government contended that du Pont had the power to control the price of cellophane and to exclude competitors from the market. Du Pont's defense was that competition from other packaging materials prevented it from exercising monopoly power. The Supreme Court, by a vote of four to three, upheld the District Court's decision that du Pont did not possess monopoly power in the sale of cellophane because of competition from substitute products.[15]

The concept of monopoly is always relative to a market. In the Cellophane case, the decision turned primarily on what was the relevant market in which du Pont sold cellophane—i.e., was it cellophane or flexible packaging materials? "If cellophane is the 'market' that du Pont is found to dominate," Justice Reed declared, "it may be assumed it does have monopoly power over that 'market.'" Justice Reed's opinion, however, was that interindustry competition (substitute products) provided degrees of competition which made it necessary to consider "commodities reasonably interchangeable by consumers for the same purposes" as the relevant market. The commodities considered to be reasonably interchangeable included aluminum foil, waxed paper, glassine, pliofilm, Saran, vegetable parchment, and other films (see Figure 21).

The government contended that since these various products are different in kind, as well as in price, they constituted a series of markets distinct from the market for cellophane. Cellophane alone, it declared, was the relevant market. The government presented evidence showing that cellophane is a unique product and that its closest rivals—glassine, sheet gelatin, and tin foil—were significantly different in price and quality and offered no serious competition. The Court, however, impressed by the availability of substitute products, rejected this argument and held that in the broader market for "flexible packaging materials" the defendant had no monopoly.

The Cellophane case is important because of its discussion of the market concept which needs to be considered in a charge of monopoly. In the words of the Court:

The "market" which one must study to determine when a producer has monopoly power will vary with the part of commerce under consideration. The tests are constant. That market is composed of products that have

[15] *U.S.* v. *du Pont* (Cellophane), 351 U.S. 377 (1956).

FIGURE 21. Competitive Substitutes for Cellophane. The numerals indicate the number of major producers. Cellophane is one of the more concentrated businesses, with only three producers (du Pont, Olin Mathieson, and American Viscose). The Supreme Court found that there are a dozen-odd products, made by dozens of firms, which make up the flexible packaging market. (Courtesy of E. I. du Pont de Nemours)

reasonable interchangeability for the purposes for which they are produced—price, use and qualities considered. While the application of the tests remains uncertain, it seems to us that du Pont should not be found to monopolize cellophane when that product has the competition, and interchangeability with other wrappings, that this record shows.[16]

The decision in the Cellophane case has been sharply criticized by many economists and lawyers. Professor George W. Stocking, for example, has declared: "If cellophane is merely a flexible wrapping material, the courts might as readily conclude that airlines, railways, bus lines, and river steamers

[16] *U.S.* v. *du Pont* (Cellophane), 351 U.S. 404 (1956).

are merely transportation facilities; that aluminum, copper, brass, and steel are merely metals; and that cotton rugs, linen rugs, nylon rugs, braided rugs, linoleum, and similar substitutes are merely floor coverings. Monopolization of one such item need not violate the Sherman Act."[17]

In an economic sense, the various units of a market good (for which a charge of monopoly is considered) should be alike in kind and approximately the same in quality. The various units should be equally fit to meet the needs of a substantial number of buyers. If the various products are not interchangeable in use, there are two or more markets, not one. A basic principle of economics is that in a market the units of a product should be subject to the principle of indifference—i.e., each unit should be interchangeable in use.

SUPPLEMENTAL LEGISLATION TO CURB MERGERS

The failure of the Sherman Act (as construed by the courts) to halt the growth of monopolistic mergers led Congress in 1914 to place a new restraint on mergers. Typically, mergers had been and were then being formed by the corporate acquisition of stock in separate and competing enterprises. A large corporation could exchange a portion of its stock for the stock of a competing plant, or it could use its cash to acquire a controlling interest in the outstanding stock. In an effort to stop this widely used method of restricting independent enterprise, and thus to nip monopoly in the bud, Congress included in the Clayton Act (1914) a provision prohibiting monopolistic mergers. Section 7 provided that "no corporation engaged in commerce shall acquire . . . the whole or any part of the stock . . . of another corporation . . . *where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition*, or to restrain such commerce in any section or community, or tend to create a monopoly in any line of commerce." The Clayton Act, Congress provided also, may be enforced either by the Department of Justice or by the Federal Trade Commission.

Soon after the Clayton Act was adopted, corporation lawyers observed that Section 7 did not say anything about corporate action to acquire the *assets* of competitors. Instead of acquiring the stock of a competing firm, it was evident that a corporation could buy the firm's assets outright, just as a person might buy an automobile or a house. Thereupon, corporations seeking to build up their control over other concerns turned their attention to an acquisition of the assets of rival corporations. The decision of the Supreme Court in the Steel case (1920) indicated that the Court was willing to accept mergers in the absence of ungentlemanly conduct, and business leaders proceeded forthwith to form mergers on a broad scale by an acquisition of assets.

[17] George W. Stocking, "Economic Change and the Sherman Act," *Virginia Law Review*, May, 1958, p. 578.

In acquiring the assets of a corporation, corporation executives sometimes found that it was *first* necessary to acquire the stock of a rival firm. By controlling a part or a majority of a rival's stock, a corporation could readily compel, induce, or direct a rival to sell its assets. Many large corporations, therefore, adopted the practice of first acquiring the stock of a rival and then of using the stock to acquire the assets.

The Supreme Court in 1926, by a five-to-four decision, held that the Federal Trade Commission had no power to curb mergers if the acquiring corporation had used its stock purchases to acquire the assets before the Commission had issued its complaint. In the opinion of the Court, the plain language of Section 7 does not prevent the acquisition of physical assets of competing concerns.[18] Later, in 1934, also by a bare majority, the Court held that the Commission was powerless to act if a corporation used its stock purchases to acquire assets before the Commission had issued its final order banning the acquisition of the stock.[19] As a result of these decisions, the action taken by Congress in 1914 to prevent monopolistic mergers was completely nullified.

THE ANTIMERGER ACT OF 1950

The Department of Justice and the Federal Trade Commission repeatedly urged Congress to plug the loophole in Section 7 by amending the Clayton Act to prohibit the acquisition of assets, as well as stock. Finally on December 29, 1950, the essential legislation was enacted. The amendment prohibits the acquisition of stock *or assets* "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." All types of mergers are banned—vertical, horizontal, and conglomerate—provided it can be shown that the effect *may be* a substantial lessening of competition or a tendency to create monopoly.

The original Section 7 prohibited any acquisition where the effect may be substantially to lessen competition *between the corporation whose stock is acquired and the corporation making the acquisition.* A literal application of this rule would prohibit the merger of two *small* companies. Since a merger of two small companies might be desirable in building up a stronger competitor, Congress revised Section 7 to condemn acquisitions which *substantially* lessen competition in any section of the country. By using the term "substantially," Congress sought to avoid a concern over trifles.

Congressional committee reports indicate that the main idea of the revision was to bar the merger of two large firms or a large firm with a small

[18] *FTC* v. *Western Meat Co., Thatcher Mfg. Co.* v. *FTC*, and *Swift and Co.* v. *FTC*, 272 U.S. 554 (1926).

[19] *Arrow-Hart and Hegeman Electric Co.* v. *FTC*, 291 U.S. 587 (1934).

one, and not that of two *small* companies.[20] The Senate Judiciary Committee, in particular, emphasized, "The committee wish to make it clear that the bill is not intended to revert to the Sherman Act test. The intent here, as in other parts of the Clayton Act, is to cope with monopolistic tendencies in their incipiency and well before they have attained such effects as would justify a Sherman Act proceeding."[21]

USE OF SECTION 7 TO CONDEMN VERTICAL ACQUISITION (MERGER)

In a case brought in 1949 against du Pont, the Department of Justice charged the company with violations of Sections 1 and 2 of the Sherman Act in acquiring and holding approximately 23 percent of the shares of General Motors. As an afterthought in its brief, the Department charged also a violation of Section 7 of the Clayton Act, as it stood from 1914 to 1950. Unexpectedly, the majority of the Supreme Court based its decision in 1957 solely on the ground that Section 7 of the original Clayton Act had been violated.[22] In a dissenting opinion on the case, Justice Burton declared, "Thus, over 40 years after the enactment of the Clayton Act, it now becomes apparent for the first time that Section 7 has been a sleeping giant all along."

The primary issue in the du Pont (General Motors) case was whether du Pont through its ownership of some 23 percent of the shares of General Motors had secured control of General Motors and had used this control to insure a protected market for its automobile finishes, fabrics, and chemicals and also preference for chemical discoveries which General Motors might develop. The District Court found that du Pont had not been a controlling force in General Motors affairs.

Upon appeal, the Supreme Court reversed the lower court. In its view, du Pont's substantial ownership of stock in General Motors had anticompetitive effects condemned by Section 7. The facts of the record, the majority concluded, plainly reveal that "du Pont purposely employed its stock to entrench itself as a primary supplier of General Motors' requirements for automotive finishes and fabrics." Justice Brennan, speaking for the Court, stated:

> It is not requisite to the proof of a violation of Section 7 to show that restraint or monopoly was intended.
>
> The statutory policy of fostering free competition is obviously furthered when no supplier has an advantage over his competitors from an acquisition

[20] *Corporate Mergers and Acquisitions, 1949–1950,* Hearings Before a Subcommittee of the Committee on the Judiciary, United States Senate, 81st Congress, second session, 1950, pp. 131, 135–138.

[21] Committee on the Judiciary, United States Senate, Report 1775, 81st Congress, second session, 1950, pp. 4–5.

[22] *U.S.* v. *du Pont* (General Motors), 353 U.S. 586 (1957).

of his customer's stock likely to have the effects condemned by the statute. We repeat, that the test of a violation of Section 7 is whether at the time of suit there is a reasonable probability that the acquisition is likely to result in the condemned restraints.[23]

The du Pont (General Motors) decision is significant because it presents a narrower concept of the "relevant market" for use in considering the power of a large seller over price. The Justices who wrote the majority opinion in the General Motors case (1957) were in dissent in the Cellophane case (1956). Now in majority, they narrowed the area of competition to be considered in a monopoly charge. In their words, "Determination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act because the threatened monopoly must be one which will substantially lessen competition within the area of effective competition."[24]

The Court found that *automotive* finishes and fabrics—not general industrial finishes and fabrics—had "sufficient peculiar characteristics and uses to constitute their products sufficiently distinct from all other finishes and fabrics to make them a 'line of commerce' within the meaning of the Clayton Act."[25]

In holding that du Pont had violated Section 7 of the Clayton Act, the Court ordered that a divestiture plan be developed by the District Court, which originally heard the case.

PROPOSED BETHLEHEM STEEL-YOUNGSTOWN MERGER ENJOINED

On November 20, 1958, the United States District Court enjoined the Bethlehem Steel Company from acquiring the Youngstown Sheet and Tube Company. This action was brought by the Department of Justice under Section 7 of the Clayton Act, as amended.

Bethlehem and Youngstown, the second and sixth largest steel producers, made a merger agreement in 1956; the government sued to enjoin its completion. The District Court held in 1958 that the proposed merger would violate Section 7 because (1) there was a reasonable probability that direct competition between the two corporations would be substantially lessened and (2) the proposed merger would eliminate Youngstown as a substantial buyer of certain steel products from other suppliers.

The defendants sought to justify the merger by urging a broad definition of the market (as in Cellophane case) to show that the total product market—steel and nonsteel products—would not be adversely affected. The

[23] *U.S.* v. *du Pont* (General Motors), 353 U.S. 607 (1957).

[24] *Ibid.*, 593.

[25] For a detailed analysis of the du Pont (General Motors) case, see R. W. Harbeson, "The Clayton Act: Sleeping Giant of Antitrust?" *American Economic Review*, March, 1958, pp. 92–104.

government, on the other hand, used the relevant market concept laid down in the du Pont (General Motors) case in which "a line of commerce" was considered to be a product or series of products having sufficient peculiar characteristics to make them distinct from other products.

Judge Weinfeld in the Youngstown case refused to place nonsteel products —such as plastic and nonferrous metal products—in the same category as steel products. In his words, "Each has its own competitive standards and markets." The line of commerce to be considered in Section 7 cases, he declared, is determined by the "peculiar characteristics" of a given product or products which make them distinct from others.[26] Within the relevant market of iron and steel products, the Court concluded that there was a reasonable probability that the merger would substantially lessen competition.

THE SHERMAN ACT AND REFUSAL TO SELL

A principal antitrust complaint in recent years is that of refusal to sell. As a business practice, refusal to sell means the selling of a certain commodity to some buyers and a denial to others, either completely or partially, when all stand willing and able to pay the asking price and to meet the terms of sale. Economists have long considered refusal to sell to be the most aggravated form of discrimination, for it means, in substantial degree, the denial of market supplies to some would-be buyers.

Refusal to sell is a business practice of large company size—or of several large companies acting as one. It takes numerous forms:

1. Refusal by large primary, integrated producers of basic commodities—such as steel, copper, lead, zinc, cement—to sell to merchant-dealers, central distributors, and speculators, who would compete in selling supplies to consuming industries.
2. Refusal by large primary, integrated producers of basic commodities to sell to independent fabricators who compete with fabricating subsidiaries of the primary producers.
3. Refusal by a primary producer of basic products—such as cement—to sell to jobbers, wholesalers, dealers or users which are not regarded or classified by the supplier as "legitimate," "ethical," "preferred," "selected," or "desirable."
4. Refusal by large, integrated producers of basic products to sell to various independent fabricators during a sellers' market in which price does not rise and supplies must be allocated.
5. Refusal to sell by a supplier, or group of suppliers, to wholesalers and retailers who do not resell at suggested prices. This is a principal reason for the practice of refusal to sell.

[26] *U.S.* v. *Bethlehem Steel Corp.*, 168 F. Supp. 576 (1958).

6. Refusal by a primary supplier to sell because of threats or coercion by others to deny supplies to certain would-be buyers.
7. Refusal by a large supplier to sell unless customers agree to accept tie-in deals or exclusive dealing arrangements.
8. Refusal by a manufacturer of final products—silverware, cameras, electrical appliances, farm machinery, etc.—to sell except to "selected" dealers, "well-established" specialty stores, or franchised dealers.

Refusal to sell, as a business practice, is based upon some degree of monopoly power. Its use rests upon a control of such a large fraction of the supply of certain goods that a seller is able to gain by refusing to sell to *some* buyers. This gain arises because the would-be customers denied supplies are required to restrict their business activity.

An early case, which still serves as a pivot in the law on refusal to sell, is that of *U.S.* v. *Colgate*. In this case, the government charged oral refusals to sell to price cutters. The Court denied relief and held that absent on antitrust restraint, a seller has unrestricted freedom of customer selection. Justice McReynolds stated: "In the absence of any purpose to create or maintain a monopoly, the [Sherman] Act does not restrict the long-recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell."[27] As authority for this rule, Justice McReynolds cited *U.S.* v. *Trans-Missouri Freight Assn.*, in which it was stated without supporting reference: "The trader or manufacturer . . . carries on an entirely private business, and can sell to whom he pleases."[28]

Soon after the Colgate decision, the Supreme Court began to limit its broad implications. In the Eastman Kodak case, the Court held that where a single seller has control over the supply of a market good which customers need for their continued business survival, refusal to sell constitutes an illegal attempt to monopolize under the Sherman Act.[29]

In numerous additional cases, the federal courts have provided treble-damage awards or compulsory-selling decrees for would-be customers faced with denial of supplies by a seller possessing monopoly power (see Table 17).

Refusal to sell has likewise been held to be illegal in the following situations:

1. Conspiracy among sellers to deny supplies or allocate customers (see Chapter 8, pages 162–163).
2. Attempts of a manufacturer to maintain resale prices through *agreement* (see Chapter 19, pages 405–406).
3. Denial of supplies to buyers who handle competitive products (see Chapter 14, pages 323–325).

[27] *U.S.* v. *Colgate and Company*, 250 U.S. 300, 307 (1919).

[28] *U.S.* v. *Trans-Missouri Freight Assn.*, 166 U.S. 290 (1897).

[29] *Eastman Kodak Co.* v. *Southern Photo Materials Co.*, 273 U.S. 359 (1927).

TABLE 17. Representative Antitrust Judgments Containing the Relief of Compulsory Selling[a]

Name of Case	Civil Action No. and Date	Compulsory-Selling Provisions
United States v. *Parke, Davis & Co.*	C. A. 8940, eastern district of Michigan Sept. 6, 1951	IX. Defendant Parke, Davis and Defendant Lilly are each ordered and directed, within 60 days after entry of this final judgment to offer in writing to sell and, at the option of the lessee, to sell, each capsule filling machine (including auxiliary and related equipment used in connection therewith) now in the possession of their respective lessees under existing leases to such lessees upon reasonable and nondiscriminatory terms and conditions. The right to purchase under this section IX shall expire after 6 months from the date such offer of sale is received by said lessee unless he shall sooner serve notice of his election to purchase upon his lessor.
United States v. *United Shoe Machinery Corp.*	C. A. 7198, district of Massachusetts Feb. 18, 1953	7. Except for good cause, defendant shall not refuse a prospective customer's request to lease or buy a machine, of a type which defendant is currently offering for commercial lease or sale. In the event that a prospective customer is refused the privilege of buying or leasing a machine, he shall have the right to intervene in this case in this court to have his controversy adjudicated, and in such proceedings, defendant shall have the burden of proving that there is good cause for refusing to make the sale or lease.
United States v. *Western Newspaper Union, et al.*	C. A. 87-60 southern district of New York August 18, 1953	V. To the extent that, and within the territories in which, any of the defendants shall, after the date of the entry of this final judgment, engage in the manufacture, sale or distribution of ready-print, printing supplies, printing machinery or printers' services, the defendants are, jointly and severally, ordered and directed to offer to sell, and to sell, to any rural printer requesting the same, upon reasonable, nondiscriminatory prices, terms and conditions of sale (including credit terms where the extension of credit is justified by reasonable business standards): (A) Ready-print, either with or without national advertising, the purchaser to have the option of purchasing ready-print either with or without such national advertising; (B) Any and all printing supplies, printing machinery or printers' services in the manufacture, sale or distribution of which such defendant may be regularly engaged either on its own account or as sales or distribution agent for the manufacturer thereof.

United States v. *Providence Fruit & Produce, Inc., et al.*	C. A. 1533, district of Rhode Island Feb. 6, 1953	IV. The company is enjoined and restrained from: (A) Refusing to lease or rent any space to any applicant desiring to act as a receiver, wholesaler or jobber at the Produce Building, except upon the grounds (1) that the applicant is not financially responsible, or (2) that all the space desired by the applicant in the Produce Building is already leased or rented to tenants, or is the subject matter of active negotiations pursuant to section V (C) of this final judgment; or (3) that the applicant or a partner or the person in active control or management thereof has within 3 years prior to the application been convicted of a crime involving moral turpitude.
United States v. *Eastman Kodak Co.*	C. A. 6450, western district of New York Dec. 21, 1954	X. Commencing 6 months after the effective date of this final judgment and for 10 years thereafter, Eastman is ordered and directed to offer to sell and sell on reasonable and nondiscriminatory terms and conditions through its then regular distribution channels in the United States: (A) Processing chemicals or mixed chemicals then used or manufactured and used by Eastman for commercial processing of its color film or manufactured by Eastman for commercial processing of its color film; (B) Color print material used or manufactured and used by Eastman for commercial processing of its color film; so long as products so substantially similar thereto as to be interchangeable therewith are not readily available from sources other than Eastman. If Eastman does not, because of short supply, fill all bona fide orders for each of such products, Eastman must prorate such products among the then processors (including Eastman) of its color film, but in any event Eastman shall make available to others at least 50 percent of its then production of each such product.

[a] This relief has been granted by the federal courts (1) where there is local-market dominance by a given seller; (2) whenever there are no realistic, alternative supplies of a standard product, interchangeable in use; and (3) whenever the refusal to sell is being, or has been, used to further a position of market control.

Any conspiracy to deny supplies is illegal, per se. When a supplier demands that a buyer observe stipulated resale prices, he may get a promise to do so (agreement). This is illegal. However, if the supplier simply demands compliance and denies supplies to those who resell at their own prices, the denial is not illegal. Thus, in *Adams-Mitchell Co.* v. *Cambridge Distributing Co.*, the seller of Scotch whiskies denied any agreement with buyers, but admitted that his policy was to demand that buyers observe specified resale prices under threat of refusal to sell. The majority opinion, upholding such action, stated:

> It may be conceded that agreements made between sellers, or between a seller and his customers to fix the resale price of goods moving in interstate commerce, so far as not exempted by the Miller-Tydings amendment, violate the Sherman Act . . . But the evidence here does not indicate such an illegal agreement. There are legitimate means of price maintenance in spite of the provisions of the Sherman Act., e.g., *U.S.* v. *Colgate and Co.* (250 U.S. 300). Such means include a refusal to sell in the future to those who had not maintained a suggested price.[30]

In the Parke Davis case (1960) the Supreme Court affirmed the rule that a supplier may legally announce desired retail prices and then refuse to sell to those retailers who do not comply. The Court emphasized, however, that a supplier may not do more—such as acting, inducing, or attempting to persuade retailers to maintain suggested retail prices. Currently, a supplier's only privilege is simple refusal to sell.

The widespread use of refusal to sell as a device for maintaining resale prices calls for an overruling of the Colgate decision. The Colgate decision contains elements of truth, but its broad language lends authority for many refusals which, in fact, restrain the trade of others. Private traders in a competitive market can, and do, select customers upon the basis of the best bids and upon assurance of payment. They can, and do, refuse to sell until they get their asking price. But when there is a meeting of the minds on price, they sell impersonally, without discrimination.

If the right-to-buy is to be made effective, the antitrust agencies should take as their standard the liberty of seller in an open market to select customers who (1) offer cash or assured payment, (2) agree to buy a certain quantity, (3) offer the best bid price, or (4) are willing to pay the asking price. Any other form of customer selection should be subject to scrutiny to determine whether or not there is a hindering or lessening of competition between the person or persons denied supplies and those who are able to buy.

DISSOLUTION PROCEEDINGS UNDER THE SHERMAN ACT

The Sherman Act, we have noted, provides for criminal *and* civil remedies. Violations of Sections 1 and 2 are defined as criminal acts punishable by fine

[30] *Adams-Mitchell Co.* v. *Cambridge Distributing Co.*, 189 F. (2d) 913 (1950).

or imprisonment. Increasingly, however, it is coming to be seen that punishment itself is not an adequate remedy for preserving competition, especially in the case of large business combinations. The only practical remedy, many believe, is the use of dissolution, divestiture, and divorcement proceedings under Section 4 of the Sherman Act.

The inadequacy of criminal proceedings may be illustrated by the Tobacco case decided in 1946. The Supreme Court upheld the conviction of the three leading tobacco companies and found that they were guilty of monopoly in controlling the buying prices for leaf tobacco and the selling prices for cigarettes. The defendants were fined but nothing was done to create the essential conditions which give rise to effective price competition. In 1948 the House Small Business Committee reported that the "Big Three" were continuing to maintain identical prices and that there was a complete lack of price competition among the companies. In the opinion of the House Small Business Committee, the government's antitrust victory in 1946 was singularly ineffective.[31]

The main purpose of dissolution proceedings under Section 4 is to break up monopolistic conditions which cannot be terminated by a mere correction of current abuses. In taking this action against large monopolistic enterprises, government seeks to create effective competition by providing an increased number of independent competitors. How many independent firms are necessary to insure effective competition? To this question Professors Stocking and Watkins answer: "Just how many producers are necessary . . . no one can say precisely. But if society relies on effective competition to protect—and promote—its interests, policy should aim at as many firms as is consistent with the economies of scale."[32]

DISSOLUTION, DIVESTITURE, AND DIVORCEMENT

The remedies of dissolution, divestiture, and divorcement are popularly called "DDD" actions. An equity suit requesting dissolution means that the government seeks to dissolve—to put out of business—an illegal combination or trade association. The term "divestiture," on the other hand, is generally used to mean that a defendant is required to divest—or dispossess—itself of particular plants, securities, or other assets. Divestiture is used by the government in order to set up competing firms, and ordinarily the dominant company itself is not dissolved. The term "divorcement" is frequently given a meaning similar to that of divestiture. Increasingly, the three terms are being used interchangeably to describe the process of separating stock holdings or physical assets from a defendant in an antitrust suit as a part of the relief ordered in the final judgment (see also Table 18).

[31] *Monopolistic and Unfair Trade Practices*, Select Committee on Small Business, 80th Congress, second session, House Report 2465, December, 1948, p. 11.

[32] George W. Stocking and Myron W. Watkins, *Monopoly and Free Enterprise* (New York, 1951), p. 112.

TABLE 18. Some Leading Antitrust Divestiture Cases

1. *U.S.* v. *Northern Securities Co.*, 193 U.S. 197 (1904). The decree ordered separation of control of the Great Northern Railway Company and the Northern Pacific Railway Company, having parallel, competing lines between the Great Lakes and the Pacific Northwest. The holding company was required to distribute its stock in the two railroads to its stockholders.
2. *U.S.* v. *Standard Oil Co. of New Jersey*, 221 U.S. 71 (1911). The Standard Oil Company controlled some forty-five companies and had acquired monopoly power over all parts of the oil industry. The stock held by Standard was ordered by the court to be distributed to its shareholders.
3. *U.S.* v. *American Tobacco Co.*, 221 U.S. 106 (1911). This case involved monopolization of the tobacco industry. The American Tobacco Company was ordered to distribute its stock interests in various subsidiary tobacco companies to its shareholders.
4. *U.S.* v. *du Pont*, 188 Fed. 127 (1911). In this action, involving a monopoly of smokeless powder, the company was required to create two new companies from the assets held and then distribute the shares of each company to its shareholders.

All the available evidence indicates that the possibility of securing effective competition is greatly enhanced by the presence of numerous independent producers. With numerous independent sellers, there is a greater diversity of interests and a wider range of judgments. A reduction in financial size, moreover, greatly reduces the power of a concern to engage in discriminatory and cutthroat pricing.

Centralized markets in the American economy declined and disappeared with the rise of mergers. In exploiting their monopoly power, dominant concerns adopted policies, such as sales to consumers alone, sales at delivered prices only, and output curtailment, which have had the effect of restricting or completely preventing market activity. The experience of the antitrust agencies has been that orders against particular abuses cannot be made effective as long as discretionary power over supplies and prices exists, for dominant sellers are usually able to devise new patterns of control when current ones are forbidden. The only effective way to curb abuses in many sectors of the economy without resorting to direct control or ownership, it is reasoned, is to reduce dominant power which gives rise to anticompetitive effects.

RELUCTANCE OF THE COURTS TO INTERFERE WITH PROPERTY RIGHTS

Although the courts have wide powers under the Sherman Act to order divestiture, they have been exceedingly reluctant to use them. From 1890 to 1960, over 400 judgments have been entered containing provisions for dissolution and divestiture. Most of these decrees, however, have been worked out on a consent basis.[33]

[33] According to the *Report of the Attorney General's National Committee to Study the Antitrust Laws,* "over the 60-odd years of Sherman Act history, courts have in only 24 litigated cases entered decrees, requiring divorcement, divestiture, or dissolution."

In numerous instances, the courts have declared that divestiture is a "harsh" and "an extraordinarily difficult and expensive undertaking."[34] When divestiture is decreed, moreover, it usually is employed in a mild way. In the consent decree in the first International Harvester case (1918), for example, the company agreed to sell three lines of harvesting machinery. The company continued to control some two-thirds of the national output of harvesters; and subsequently, when the Department of Justice asked for further relief, the Court refused the request on the ground that "competitive conditions in the trade" had been established.[35] The fact was, however, that the farm machinery industry was then, and had long been, characterized by price leadership, concentration of output, and administered prices.

Similarly, in the American Tobacco case (1911), the Court indicated that it was unwilling to create any considerable number of competitors. It is reported that before the formation of the American Tobacco combination there were some 276 cigarette manufacturers in the United States.[36] Subsequently, the American Tobacco Company acquired a control of more than 95 percent of the cigarette production. In formulating the dissolution decree for the American Tobacco Company, the Court was urged to divide the combination into *sixty* different companies. The Court declined to do so, however, and created instead *three* "full line" companies. These companies were given a large part of the production facilities for making smoking and chewing tobacco and all of the facilities for making cigarettes owned by the combination.

One significant victory won by the Antitrust Division was the decree against the "Big Five" motion picture producers. In a series of cases extending over a period of fourteen years (1938–1952) the government secured consent decrees forcing the major producers to sell their affiliated exhibition outlets. The decrees also provided for a considerable measure of dissolution in the established exhibition companies. Under the five decrees, the court ordered that more than 1200 theaters be sold to independent exhibitors and that some 1300 theaters be operated by newly formed theater companies. The results secured in the motion picture cases, however, are not typical of other dissolution decrees. The motion picture dissolutions were secured *in consent decrees*, in which the defendants consented to accept a court order. The case is important primarily because of the changes which were effected in the business world by the consent decrees.[37]

When a defendant vigorously resists remedial action, the records show that the courts proceed with much consideration for private property. In a concurring opinion in the Timken Roller Bearing case (1951), Justices Reed and Vinson, for example, declared that dissolution "is not to be used indis-

[34] *Timken Roller Bearing Co.* v. *U.S.*, 341 U.S. 593 (1951), and *U.S.* v. *General Electric Co.*, 115 F. Supp. 835 (1953).

[35] *U.S.* v. *International Harvester Co.*, 274 U.S. 693, 704 (1927).

[36] *Monopolistic and Unfair Practices*, *op. cit.*, p. 10.

[37] *U.S.* v. *Paramount Pictures*, 334 U.S. 131 (1948).

criminately, without regard to the type of violation or whether other effective methods, less harsh, are available."[38] In the National Lead case (1947) the Supreme Court refused to create two additional titanium pigment plants from the facilities of National Lead and du Pont. The record showed that du Pont and National Lead controlled 91½ percent of the output of pure titanium and 100 percent of the production of titanium pigment. In denying divestiture, the Court stated: "To separate the operating units of going concerns without more supporting evidence than has been presented here to establish either the need for, or the feasibility of, such separation would amount to an abuse of discretion."[39]

Likewise, in the Alcoa decision (1950), the court refused to create a new producer from the Alcoa empire on the ground that there was competition in the presence of the Reynolds and Kaiser companies. As long as there is more than one seller, the courts appear to believe that there is the "competition" called for by the antitrust laws.

How can one explain the reluctance of the courts to dissolve monopolistic mergers? Is it because economic or technological factors have made it clear to the justices that any substantial degree of decentralization would be undesirable? A careful reading of the dissolution judgments does not indicate that this has been the case. The factors controlling the actions of the courts appear rather to have been (1) the use of inadequate and incomplete concepts of monopoly and competition and (2) an unwillingness to disturb property relationships, except in cases characterized by flagrant abuses. "Constitutional law," Professor E. S. Corwin declares, "has always a central interest to guard."[40] In the past this "central interest" has been business property and, in particular, business corporations. Whether or not the personnel of the federal courts, and especially the Supreme Court, will become increasingly procompetition and proconsumer rather than promonopoly and procorporation only the future will tell.

SOME CONCLUSIONS ON DISSOLUTION PROCEDURES

If the economic problem of monopoly is to be solved within the framework of the Sherman Act, it is certain that increasing attention will need to be given to the problem of the large business combinations which now characterize American industry. No critic of mergers proposes to limit the physical size of any plant or to deny a company the right to own more than one plant. The basic question is whether or not acquisitions—past or prospective—restrain price competition. Price-fixing agreements among competing plants are illegal per se, and many economists and lawyers believe

[38] *Timken Roller Bearing Co.* v. *U.S.* 341 U.S. 593, 603 (1951).
[39] *U.S.* v. *National Lead Co.*, 332 U.S. 319 (1947).
[40] E. S. Corwin, *The Constitution and What It Means Today* (Princeton, 1947), p. viii.

that the same rule should be applied to all mergers which restrain price competition. The application of such a rule will not eradicate all monopoly from the fields of general business, but it will mean the taking of a long step in that direction.

Mr. George E. Hale, in a special study of dissolution decrees, concludes that our experience with the mechanics of separating monopolistic combinations proves that dissolution proceedings have not presented insuperable problems.[41] It is frequently said that "you cannot unscramble an egg." This is true for scrambled eggs, but it is not true for business mergers! If we have the will to dissolve monopolistic mergers, our experience shows that we can find a way to do it.

The effectiveness of dissolution proceedings in the past has been greatly impaired by the willingness of the courts to place the stock of the newly created entities in the hands of the same body of stockholders which controlled the combination. As an alternative procedure, Mr. Hale proposes that the courts "give all the shareholders of the combination proportionate share interests in all the successor units but require them, within a reasonable time, to elect in which one company they will retain shares, the others to be sold." This plan, it is believed, would promote a much larger degree of decentralization in the ownership of corporation securities in particular industries.

Antitrust experts suggest that in handling new dissolution cases the government should deal with an entire industry at one time. A suit to dissolve the United States Steel Corporation, for example, would be unfair and unwise unless it were made to include other monopolistic mergers in the steel industry. In view of the duration and complexity of dissolution proceedings, it is also believed that the working out of plans for dissolution should be handled by an administrative body. The decrees of the district courts, subject to appeal to the higher federal courts, ultimately determine the effectiveness of the Sherman Act. For this reason it is highly important that the district judges be given expert economic assistance in formulating divestiture decrees, as well as injunctions requiring the observance of certain business practices.

Section 7 of the Federal Trade Commission Act (1914) provides that in civil suits the court may refer the case to the Commission, as a master in chancery, to ascertain and report on an appropriate form of decree. Thus far the courts, in general, have not made use of this service. It is possible that legislation should be adopted to require them to utilize the services of the Commission in formulating antitrust decrees. The courts, however, at all times should be permitted to have the final determination of the case, in order to preserve the matter as a case or controversy in the courts of the United States.

[41] George E. Hale, "Trust Dissolution," *Columbia Law Review*, April, 1940, p. 631.

SUMMARY ON THE INTERPRETATION OF THE SHERMAN ACT

With the development of business restraints in the United States, the American courts began to apply the common-law doctrine of restraint of trade. All general restraints were held to be void, and partial restraints were held to be reasonable if based upon a proper consideration. Subsequently, the doctrine of restraint of trade was extended to price-fixing agreements made by competitors, all of whom continued in business. Such price-fixing agreements were held to be unreasonable and void. Strictly speaking, they were general restraints and void regardless of their reasonableness.

In 1911 the Supreme Court applied the idea of reasonableness *to mergers* which completely restrained independent price competition among former competitors. Thereupon, the "rule of reason" became the sole test of the validity of all restraints—partial and general—except that direct price-fixing agreements were held to be per se unreasonable. Restraints on price competition imposed by a merger were accepted as long as the merger (1) did not acquire an overwhelming percentage of the separate plants in the nation or (2) did not engage in predatory practices. This rule of judge-made law is known variously as the abuse theory of mergers, the abuse theory of monopoly, and the "Sherman-Act test" for mergers.

Although the Supreme Court has interpreted the Sherman Act so that little, if any, restraint is placed upon price unity secured by means of corporate mergers, it has consistently condemned such unity whenever it is secured by agreement among legally separate firms. All conspiracies suppressing price competition are held to be contrary to public policy and violative of the Sherman Act. A finding of conspiracy, the courts have held, may be based upon (1) circumstantial evidence and inference of agreement or (2) evidence of direct agreement.

In the Alcoa case the federal courts made distinct progress toward correcting the divergent policy of (1) condemning price agreements and (2) accepting mergers of competing plants. For the first time, they indicated that they were prepared to condemn monopoly, as such, whether secured by collusion or by financial size, and without reference to the existence of predatory practices. In the Alcoa case, Judge Hand reasoned that the possession of power to control prices necessarily means that it will be exercised in the making of prices. Monopoly power, as the power to manage prices, was, therefore, condemned as such, without reference to specific abuses.

The decision in the Alcoa case turned on the presence of monopoly power rather than on bigness, as such. The rule that size, per se, is not prohibited by the Sherman Act still stands. The antitrust laws are concerned not with size, but rather with monopoly power. In the view of the court, *monopoly*, as applied to one single company, *is the power to exclude competitors or to*

fix or control prices. The existence of monopoly, it was held, provides the basis for dissolution, divorcement, or divestiture proceedings.

The advanced position taken in the first Alcoa case (1945) condemning the power to fix, control, or make the going price, has been weakened in subsequent decisions. Discretionary control over price was not condemned in the second Alcoa decision (1950), because of the strength of competitors and the needs of national defense; or in the Columbia Steel decision (1948), because the market share controlled was not "unreasonable"; or in the Cellophane decision (1956), because of the presence of substitute products.

The weakest aspect of our antitrust law program centers on the application of the Sherman Act to price leadership and oligopoly. There is a growing economic and legal opinion that the antitrust laws *can* and *should* be applied to (1) price leadership and (2) unified selling by a few dominant concerns which act as one on price, allegedly without agreement. The antitrust laws, various authorities believe, can be applied against price leadership on the principle that monopoly is the power to fix or control prices (Alcoa case). The situation of oligopoly, moreover, might be attacked (1) on the principle of implied conspiracy or (2) as a condition of monopoly—under Section 2 of the Sherman Act—on the theory that the larger companies jointly or collectively possess the power to control prices.

The large monopolistic mergers and the economic concentration which have been permitted to develop under the Sherman Act show clearly that we have gotten off on the wrong road in our interpretation of the concepts of monopoly and competition. Vast corporate mergers, which completely eliminate the price competition of formerly independent plants, may be legal under the Sherman Act as interpreted by the courts in the past, but they make it impossible for our nation to maintain a policy of effective price competition. There is a substantial body of opinion among economists and legal experts that the only alternative to succumbing to monopoly power is to reduce the size of that power through a dissolution or divestiture of the larger mergers. We have never really tried this policy, except in a very limited way.

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10

The Administration of the Sherman Act

PURPOSE AND SCOPE OF THE SHERMAN ACT

Although uncertainty frequently exists with respect to the interpretations placed upon the Sherman Act, there is general agreement that the fundamental and consistent purpose of this statute is to (1) prevent the exercise and growth of monopoly and (2) retain as far as possible, and restore, the business practices of free enterprise and price competition. The processes of the Sherman Act are legal in nature, but its substance and purpose are essentially economic. Monopoly, mergers, price discrimination, pricing formulas, freight absorption, phantom freight, mill net prices, free enterprise, price competition, markets, and market price are basically economic concepts. Persons in charge of enforcing and applying the antitrust laws have before them the opportunity and responsibility of shaping and directing business conduct along lines which give effect to the principles of competition. The Sherman Act is not merely an "antimonopoly" statute designed to punish past illegal conduct. It is also a "procompetition" statute; and the Attorney General, as well as a private individual, is authorized to initiate civil suits to restrain violations and to create the conditions which are necessary for the operation of fair and orderly competition.

In principle, the Sherman Act is applicable to all business activity (including banking) carried on among the states, with foreign nations, and in and with territories subject to the jurisdiction of Congress, unless specific exemptions have been made or provided by judicial interpretation of general language. In practice, however, it is applied mainly to the fields of general business, particularly manufacturing and merchandising. Since its adoption in 1890, suits have been brought against firms and individuals in the various lines of general business, as well as in the fields of insurance; medical services; the small-loan business; automobile financing; labor organization; motion picture production and distribution; the railroad and motor transport industries; the distribution of milk, poultry, and other agricultural products; the production of coal, natural gas, and other extractive commodities; retail food distribution; news reporting; newspaper publishing; music publishing;

the making of loans secured by mortgages; commercial fishing; the professional team sports of football, basketball, and hockey; and the broadcasting and telecasting of professional games.

ENFORCEMENT OF THE SHERMAN ACT

In 1903 a special Antitrust Division was created in the Department of Justice to enforce the Sherman Act. This agency is headed by an "Assistant Attorney General, Antitrust Division," and includes attorneys, economists, and special investigators. The Antitrust Division administers the Sherman Act and related antitrust statutes and joins with the Federal Trade Commission in exercising concurrent jurisdiction under the Clayton Act. In addition to its duty of enforcing the antitrust laws, the Division has the responsibility of enforcing the administrative orders of the Federal Trade Commission, Interstate Commerce Commission, Civil Aeronautics Board, Federal Communications Commission, Securities and Exchange Commission, Commodities Exchange Commission, and the Secretary of Agriculture. The Solicitor General handles all litigation before the Supreme Court which arises over the orders issued by the foregoing administrative agencies.

An additional activity of the Antitrust Division consists of consulting with businessmen on the legality of proposed trade association activity, business mergers, and prospective commercial policies. In reviewing the proposals which are presented to it, the Division asks for a full disclosure of all relevant facts. If the parties concerned agree to eliminate features of doubtful legality, the Division will thereupon stipulate that it will not bring criminal action on the basis of the facts presented. However, it reserves the right to bring a civil action at a subsequent time, if competition appears to be restrained.

Antitrust cases originate in (1) the complaints of businessmen who are being injured by monopolistic practices, (2) the suggestions made by other government agencies, and (3) the research activity of the Division itself. About 90 percent of the cases, it is estimated, arise in the complaints of independent businessmen who report that they are being injured or threatened by monopolistic practices. Each month the Antitrust Division receives about 100 complaints from business firms, private individuals, and governmental purchasing departments.

The actual selection of cases for prosecution turns on the availability of evidence, the legal issues involved, the impending injury to small competitors, and the particular business practices which currently appear to be important ways of effecting monopoly control. The Antitrust Division develops its cases both upon the basis of investigations conducted by the Federal Bureau of Investigation and upon the evidence obtained in a grand jury proceeding called by a district court. At the present time, most of the investigations are made by the FBI, which is a unit of the Department of Justice.

USE OF CRIMINAL PENALTIES TO DETER MONOPOLY ACTION

Monopoly has long been considered to be a crime against society; and if the Division believes that a group of businessmen should be punished for their past illegal conduct, it initiates a criminal case. A criminal conviction provides for the imposition of fines or imprisonment, or both. The historical purposes of such penalties are (1) to make monopoly unprofitable and (2) to subject the monopolists to public ignominy.

Corporation officials accused of violating the Sherman Act typically have been persons of high social standing in their communities, and the Antitrust Division has found that juries and the courts have been reluctant to impose prison sentences on such persons. An example of the unwillingness of the courts to impose prison sentences on respectable businessmen is found in a case involving the General Motors Corporation. In this instance, all of the officers were found to be innocent, but the corporation itself, an impersonal entity, was convicted of monopolistic action! The fines which have been imposed in criminal cases have also reflected extreme consideration for the business interests, and it is generally agreed that they likewise have not been a deterrent to monopoly action.

CIVIL SUITS AS AN INSTRUMENT OF BUSINESS REGULATION

From an economic point of view, criminal actions to punish past illegal conduct are an incomplete and negative form of regulation. They do not resolve economic issues or make provision for the essential conditions of free enterprise and price competition. Their chief value lies in cases—such as conspiracy cases—in which all the government wants is conformity with an applicable rule of law—e.g., independent action on price.

Experience has shown that in most situations, if competition is to be maintained, government must act positively to create and maintain in the basic industries *the conditions* which are essential for the effective operation of competition (see Chapter 4, pages 54–55). It is here that civil suits become important. Their usefulness and proper role lie primarily in dealing with problems of size and market organization as distinguished from conspiracy. The undisputed purpose of the Sherman Act is to retain and restore price competition, and the principal purpose of civil suits under the act accordingly is—or should be—to provide the conditions which are essential for the operation of effective competition.

The Antitrust Division has made a commendable beginning in getting the courts to require corrective action and remedial measures to make competition work more effectively. Decrees have been entered, for example, requiring a particular industry or concern to:

1. Sell at f.o.b. mill prices at the buyer's request, in addition to any other method of price quotation.
2. Inform the Department of Justice of proposals to acquire stock or assets in other companies.
3. Refrain from opening any new branch offices for a period of five years.
4. Dispose of various plants and companies, with an injunction against a sale to officers, directors, or agents of the parent company, as well as against interlocking directorates and stock ownership in the separate businesses.
5. License patents or dedicate certain patents to the public, royalty free.
6. Sell not more than 35 percent of the total production of a basic commodity.
7. Liquidate or abandon designated trade associations.
8. Sell to all comers offering to meet the terms of sale when it has been proven in court that a seller possesses monopoly power.

No one of these requirements imposed by judicial decree is specified in the Sherman Act. Fashions in monopoly, however, change from period to period, and it is sound policy to provide a general legislative mandate against monopoly and for competition, with the particular details to be worked out by administrative agencies and the courts.

A criticism frequently made of the Sherman Act is that it lacks certainty. In large measure this fact, to the extent that it is true, arises from the fewness of antitrust cases which have been decided. What is needed is more decisions applying the Sherman Act which will provide "rules of the game" to make competition fair, aboveboard, and effective.

Over the years our failure to regulate and implement competition has led to the widespread growth of monopoly. At the present time, government has the triple task of (1) *eradicating* monopoly, (2) taking steps to prevent the adoption of new monopolistic practices, and (3) providing positive rules for the regulation of competition.[1] Civil decrees, which provide affirmative relief, have an important role to play in the fulfillment of this task, for they make it possible for government to require by court order the observance of rules and conditions making for effective price competition.

SETTLEMENT OF CASES WITHOUT PRESENTATION OF EVIDENCE

In recent years the Antitrust Division has settled a substantial majority of its antitrust cases by means of consent judgments, without bringing a case to

[1] Examples of positive rules which various economists have suggested for governmental adoption are (1) the requirement of f.o.b. mill prices, uniform to all buyers at the mill; (2) the rule that producers of standard products who hold themselves out as dealing with the public, and who control a substantial percentage of the output in their area of practical shipment, shall sell to all comers offering to meet the terms of sale; and (3) the provision of publicity on the prices of actual transactions, sales, and supplies available.

trial. In 1957, for example, more than seven-eighths of all the civil antimonopoly cases terminated were concluded with consent decrees. At present, only one of every four alleged violators stands trial. The settlement of cases without the taking of evidence saves time and money. Government attorneys desire to save money in order to prosecute additional cases. Private defendants, on the other hand, are quite prepared to settle a case quickly when they are convinced that they are going to lose it.

When a case involves a clear-cut violation and the government is able to secure all of the relief it requests, there is clearly no reason for litigation. In all other cases, however, consent settlements rarely operate to serve the public interest.

There is substantial evidence indicating, for example, that in many consent settlements the government secures far less relief than was requested in the complaints. In the American Telephone and Telegraph Company case (1956), the government sought to promote competition in the manufacture and sale of telephone equipment by divesting A.T.&T. of the Western Electric Company, its manufacturing subsidiary. The consent settlement actually provided only that A.T.&T. release a few patents. These patents, a Congressional committee reports, are of little value to independent manufacturers, for A.T.&T. continues to buy its equipment from its own subsidiary.[2]

A second defect of consent settlements is that they cannot be used by private parties in treble damage suits. The Clayton Act provides that "a final judgment or decree" in any antitrust case, "to the effect that a defendant has violated said laws," shall be *prima facie* evidence of illegal action in a private suit for treble damages. Any person injured by the monopolistic practice can introduce the judgment or decree, and thereupon he needs only to prove the damages sustained. Consent decrees and judgments on pleas of *nolo contendere*, however, have been held *not* to constitute "a final judgment or decree," and thus they do not provide a basis for treble damage suits. Violators of the antitrust laws frequently worry more about treble damage suits than about public penalties, and they accordingly are quite willing to accept court settlements which preclude private liability.

A further criticism of consent settlements is that they result in judgments which are exceedingly difficult to enforce. Without a court trial and the presentation of evidence, there is no record of the practices to be forbidden. A slight change in pricing methods or business practices may be enough to divert government personnel concerned with compliance. Rarely, it has been found, does the Antitrust Division make an effort to enforce consent settlements.[3]

[2] *The Role of Private Antitrust Enforcement in Protecting Small Business*, Select Committee on Small Business, 85th Congress, second session, Senate Report 1855, 1958, p. 4.

[3] *Final Report*, Select Committee on Small Business, 85th Congress, second session, House Report 2718, January 3, 1959, p. 105.

TREBLE DAMAGE SUITS AS AN INSTRUMENT OF ENFORCEMENT

The Sherman and Clayton Acts provide that "any person who shall be injured in his business or property" by monopolistic practices may sue for threefold the damages sustained, regardless of the amount of the injury. The term "any person" includes consumers, and it appears that a consumer, or group of consumers, could bring action against price-fixing conspiracies for overpayments on the products they buy.

Business enterprises have made, and are now making, extensive use of the "treble damage" provisions. Instead of complaining to the government about an injurious practice or about exclusion from the business field, an enterpriser may initiate a private damage suit.

In recent years, there have been at least five times as many private treble damage suits as government prosecutions (see Table 19). Most of the private suits are settled out of court, for the defendants are anxious to suppress publicity on their illegal acts.

TABLE 19. Government and Private Antitrust Cases Commenced During the Years 1946–1958

	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958
Government cases:													
Civil	18	33	19	39	42	37	20	16	21	33	30	38	33
Criminal	15	11	18	27	34	16	12	16	10	16	24	18	22
Private civil cases	68	64	78	162	157	209	261	212	163	209	227	188	270

SOURCE. Annual Reports of the Director of the Administrative Office of the United States Courts, Washington, D C

Treble damage suits provide a useful and desirable *supplement* to public prosecution. The *main* burden of enforcement, however, should be carried by the government itself, as the agency of the nation as a whole. It is only the government which can conduct a consistent and coordinated program of creating the *essential conditions* for competition. Public prosecution should be a major—not a minor—instrument for maintaining competition.

SECURING COMPLIANCE WITH COURT DECREES

When court decrees have been entered prohibiting certain business practices and requiring the observance of others, the Antitrust Division has the further task of inspecting and policing the past defendants to see whether or not they are complying with the court orders. The unfortunate fact is that the Division has had neither the staff nor the money to make continuing

checks on industry compliance. In most cases, information on decree violations has been presented to the Division by individuals who have a grievance against the past defendants.

CAUSES OF THE WEAK ENFORCEMENT OF THE ANTITRUST LAWS

It is often said that the Sherman Act has been a failure because it has not prevented the enormous growth of economic concentration and monopoly which presently exist in the United States. There is no doubt that economic concentration and monopoly have grown enormously—and are still growing. A basic factor which has contributed to this condition, economic and legal experts agree, has been the weak enforcement of the antitrust laws.[4] For many decades the Sherman Act was virtually unused. Scarcely a finger was lifted against monopoly. A summary of the cases instituted under the Sherman Act each year since 1890 shows that vigorous enforcement activity really did not get under way until about 1940. The truth is that the policy of the Sherman Act has hardly been tried.

Half-Hearted Interest by the Executive, Judicial, and Legislative Branches of Government

It is generally agreed that the major reason for the weak enforcement of the Sherman Act has been the fact that over the years our public authorities —executive, judicial, and legislative—frequently have not had the will or desire to enforce the law. At no time, moreover, has the Department of Justice had adequate funds for enforcement activity. During the administration of President Cleveland, the Attorney General, Richard Olney, a former corporation lawyer, actually worked with various business groups to get the Sherman Act repealed! From March 6, 1893, to June 7, 1895, Mr. Olney instituted only six proceedings under the Sherman Act, and all of these cases were brought against labor unions and labor leaders.[5] Even President Theodore Roosevelt, it is said, "at first roared like a lion against monopoly" but "at last cooed as gently as any sucking dove about letting business cooperate, and about the need to distinguish between good trusts and bad ones, with the disturbing implication that he would do the choosing."[6]

The federal courts, likewise, have contributed to the relative ineffective-

[4] Other important factors which have contributed to the rise of economic concentration have been (1) the legalization of the holding company device and (2) the failure of the efforts of Congress in the Clayton Act to prevent corporate mergers which substantially lessen competition.

[5] Thomas K. Fisher, "Antitrust During National Emergencies," *Michigan Law Review*, May, 1942, p. 975.

[6] Frank A. Fetter, *Democracy and Monopoly* (Princeton, 1939), p. 16.

ness of the Sherman Act. Important actions on their part which have served to weaken it have been (1) the distinction which the Supreme Court made in the Sugar Trust case (1895) between manufacturing and commerce, (2) the addition of the so-called "rule of reason" to the Sherman Act in the Standard Oil and American Tobacco cases (1911), (3) the use of the rule of reason in the Steel case (1920) to justify a merger which restrained the competition of scores of formerly independent plants, and (4) the consideration of "motives" and "abuses" in applying the Sherman Act (the abuse theory of mergers) rather than the existence of monopoly as an actual economic condition. All these instances of "judge-made" law point to the fact that the federal courts have not had an active interest in applying the Sherman Act.

Finally, Congress itself over the years has not been willing to enact supplementary legislation to prevent the whittling away of the Sherman Act by adverse court decisions. Indeed, as we shall see in the next chapter, Congress has, in fact, contributed substantially to the whittling away process by granting numerous exemptions from the Sherman Act. At all times, moreover, Congress has been unwilling to appropriate adequate funds to provide for comprehensive enforcement activity.

Why, it may be asked, have the executive and judicial branches of government often been unwilling to give wholehearted support to the Sherman Act? Why has Congress long been unwilling to provide adequate funds for its enforcement? There is general agreement that the main reason is to be found in the pressure of organized special interests and in the influence of substantial campaign contributions. As Dr. William McCracken has said, "If one were to ask me why our antitrust laws and enforcement had been of almost no avail, I would say that it is due primarily to the 'Fourth Division of Government,' namely, lobbies and pressure groups."[7] The expenses of political parties must be paid by someone, and no President, it appears, has been able to resist completely the influence of the chief financial supporters of his political party.

The influence of pressure groups may express itself in the appointment of the Attorney General and in the nomination of judges for appointment to the federal courts. Until about 1910 a majority of the appointees to the Supreme Court were men who had made distinguished records as corporation lawyers. These men had long been trained in serving the interests of large corporations and they brought to the Court a background and habit of thinking which made them unwilling to do much more than frown upon the practices of monopoly.

The apathy of the executive and legislative branches of government toward the antitrust laws has also expressed itself in the small appropriations which have been requested and granted for the Antitrust Division of the Department of Justice. Prior to 1935 the annual appropriation was never in excess

[7] Dexter M. Keezer (ed.), "The Antitrust Laws: A Symposium," *American Economic Review*, June, 1949, p. 716.

of $300,000, and frequently it was only $100,000. At no time did the Division employ more than twenty-five attorneys. During the administration of President Theodore Roosevelt, when "trust-busting" activity was put forward as a major economic function of government, the Antitrust Division consisted of five attorneys and four stenographers.

Soon after our unfortunate experience with legalized monopoly in the National Recovery Administration (1933–1935), President Franklin D. Roosevelt recommended an expanded program of antitrust enforcement. The Division's appropriation was thereupon increased from $475,000 in 1938 to $2,325,000 in 1942. Even so, according to Thurman Arnold, who was in charge of the Antitrust Division from March 7, 1938, to March 16, 1943, the appropriations secured for antitrust enforcement were sufficient only to permit the Division to be concerned with "the dramatization of an ideal." Continuous practical regulation, he stated, was out of the question. Since World War II, competent authorities report that the Antitrust Division, as well as the Federal Trade Commission, have been securing only about one-half of the funds which they need to operate effectively.

Inadequate Funds for Prosecution Compared with Resources Available to Defense Attorneys

In part, the difficulty which has been encountered in enforcing the antitrust laws is explained by the lavish expenditures which have been made by private corporations in comparison with the amounts available to the federal government. The total appropriation of the Antitrust Division for all of its work has been only around $4,000,000 per year in recent years. This appropriation is for enforcement of the antitrust laws and supplemental antitrust legislation, as well as for the preparation of reports for Congress.

It is estimated that one major antitrust suit costs the government between $350,000 and $750,000. A business combination, on the other hand, not infrequently spends several times this amount in defending a case in the federal courts. According to the Antitrust Division, one of the defendants in the Hartford-Empire case (1945) spent approximately $900,000 in the trial of the case in the District Court, and an estimated $500,000 to $800,000 in appealing the case to the Supreme Court. The expenditures of the other seven corporate defendants in the case were not known but were estimated to be in excess of $1,000,000.[8] The legal expense of the defendants in the Madison Oil case (1940) is reported to have been somewhere between $2,000,000 and $2,500,000.[9] In the Cement case (1948), it is estimated that the defendant companies spent over $11,000,000.

[8] *United States Versus Economic Concentration and Monopoly*, Staff Report to the Monopoly Subcommittee of the Committee on Small Business, House of Representatives, 79th Congress, second session, 1946, pp. 248–255.

[9] *Antitrust in Action*, Monograph No. 16, Temporary National Economic Committee, 76th Congress, third session, 1941, p. 80.

Inadequate Use of Economic Analysis by the Regulatory Agencies and the Courts in Applying the Laws on Competition

One of the principal reasons for the ineffective enforcement of the antitrust laws has been—and still is—the insufficient use of economic facts, economic analysis, and economic reasoning by the prosecution and the courts. In many instances, attorneys for the government have failed to make adequate or, in fact, any use of economic experts in important antitrust suits. Private corporations, on the other hand, have spared no expense in the employment of economists to assist in defending monopolistic business practices. Such men have been employed (1) to assist in collecting data and in framing issues and (2) to testify as expert witnesses.

PROPOSALS MADE FOR THE MORE EFFECTIVE ENFORCEMENT OF THE SHERMAN ACT

It is frequently said that the Sherman Act should be rewritten to bring it up to date with modern conditions. There is little evidence, however, that any change in the basic law is needed. Its purpose, we have said, is to prevent monopoly and to maintain and preserve competition in the principal lines of business activity. If the free competitive system is to be maintained, it is evident that the substantive law of the Sherman Act itself must be retained.

A study of the literature available on the antitrust laws shows that there are some nine main proposals currently advanced for making the Sherman Act more effective. A brief analysis of these remedial suggestions follows.

All-Needed Executive and Legislative Support of Present Statutes

The proposal most frequently urged by authorities on the Sherman Act to make its application more effective is that of providing larger appropriations for enforcement activity. The Temporary National Economic Committee, especially, emphasized in its final report (1941) that the Department of Justice and the Federal Trade Commission "are admittedly undermanned and meagerly budgeted. No law, and particularly no law of the type here discussed, can be stronger than the zeal and resources of the agencies of enforcement into whose care it is entrusted. We strongly urge the absolute necessity of providing funds for these agencies adequate to the task which confronts them."[10] Today, the need for adequate executive and legislative support continues to be as great as it was when this recommendation was written.

[10] *Final Report and Recommendations of the Temporary National Economic Committee,* 77th Congress, first session, Senate Document 35, March 31, 1941, p. 35.

Increased Penalties and a Greater Number of Litigated Cases

Many authorities recommend that the courts should be firmly requested by the government to impose more stringent penalties in criminal suits for violations of the Sherman Act. The purpose of a fine is to serve as a deterrent as well as a punishment. The present fine, the law reads, *is not to exceed* $50,000 for each violation. This means that a judge can levy *up to* that amount, but he can, and frequently does, impose a lesser fine. The penalty of prison sentences, it is also believed, should be more widely imposed.

Some antitrust authorities suggest additional forms of penalties for antitrust violations. Dr. Walton Hamilton, for example, proposes that a corporation violating the act be required to forfeit "to the United States a sum equal to twice the total of the net income accruing during the period of wrongdoing. An offending officer is likewise to forfeit to the government double the compensation he has received during the period of violation. In addition, an executive may for an appropriate period be separated from his corporate office for such malfeasance in the discharge of his duties."[11]

A principal need in antitrust enforcement, it is also recognized, is for the Antitrust Division to make a sharp reduction in the number of consent decrees which it is willing to accept. Since 1890, in fact, almost 75 percent of all civil cases have been so concluded.

Reasons for caution in the use of consent settlements were presented above on pages 210–211. When consent settlements are accepted, there is no independent judicial determination of legal issues, based upon the briefs of the parties and the merits of the case. There is no determination of whether or not certain practices attacked by the government are legal or illegal. The court does not say that the defendants are guilty of violating the law. In the really significant consent settlements, moreover, the decrees entered usually do not provide for the relief which the government requested.

It is not proposed that consent settlements be eliminated entirely. In a few clear-cut cases, it is undoubtedly possible for the government to secure the relief desired without litigation. However, when significant antitrust cases are brought, it is important to argue the case on its merits and to secure a judicial determination of legal issues. The relief requested by the government is either in the public interest or it is not, and the courts should be called upon to make this determination as an independent judicial body.

Increased Use of Economists and Economics by the Government and the Courts

The considerable use of which private business makes of economists in antitrust cases is causing the Antitrust Division to re-examine its own procedures. In 1957 Dean E. T. Grether of the University of California and

[11] *Antitrust in Action,* Monograph No. 16, Temporary National Economic Committee, 76th Congress, third session, 1941, p. 104.

Professor Carl Kaysen of Harvard were engaged to study the use of economics in antitrust enforcement.

The Grether-Kaysen report, completed in 1958, strongly recommends that economists and economic analysis play a larger role in antitrust cases. Specifically, the study urges that the present staff of economists in the Antitrust Division be "substantially expanded." In the recruitment of this staff, it is suggested that "efforts be made to attract young graduate students with advanced degrees in economics who have been trained at the universities and colleges where major graduate training in economics takes place."[12]

The Grether-Kaysen report states, particularly, that the topics of market definition, market share, price behavior, profits, and other elements of market performance now occupy a large share of the discussion in antitrust cases. These matters, it states, require economic facts, economic concepts, and economic analysis. In the Cellophane case (1956), the authors declare, the government gave too much time to previous legal cases and too little "to its (essentially correct) contentions on the great price differential between cellophane and the alleged close substitutes, and the ability of du Pont to change its prices independently of their price levels, and without invoking any corresponding change in their prices." Likewise, in the Columbia Steel case (1948), they state, the government failed to present enough economic data on market areas and the areas of competition.

The Grether-Kaysen study concludes: "Economic evidence is important in antitrust cases. Judges not only listen to it when it is offered, they sometimes ask for it when it is not, and what is offered influences findings, decisions, decrees. This is most clearly so in the courts' dealings with problems of market definition and market share. . . . [But] economic 'evidence,' strictly speaking, is not enough. Economic argument is required. The 'facts' must be placed in a conceptual framework provided by economic conceptions—theory, if you will. . . . In sum, in preparing for trial of an antitrust case, other than those involving simple and relatively clear-cut per se violations, the government must have an economic theory of the case as well as a legal theory of the case, and the first is as important as the second to success both in terms of winning the trial and in terms of achieving a meaningful remedy."

The Grether-Kaysen recommendations are timely and important. As a further step toward more effective antitrust enforcement, it is suggested that the courts, themselves, should employ economic experts to aid them in evaluating the opinions of the partisan experts. On the average, a federal judge in a district court hears only a few antitrust cases in his entire career, and there is little opportunity for him to build up a fund of experience on antitrust litigation. The typical federal judge, moreover, has had little training in economics. In 1945 the Federal Rules of Criminal Procedure were modified to provide federal judges with authority to appoint expert witnesses

[12] *Economic Evidence in Antitrust Cases, Grether-Kaysen Report*, Department of Justice, Washington, D.C., 1958.

upon their own motion. This legislation makes it possible for the federal courts to secure the services of impartial economic experts, if they so desire.

Registration of Trade Associations

A further suggestion for strengthening the Sherman Act calls for the registration of trade associations. Thus, the Temporary National Economic Committee proposed that "all trade associations whose participating members are engaged in interstate commerce be required to register with an appropriate federal agency and to file periodical reports of their activities. All such associations should also be required to give adequate publicity to all of their activities." According to the Committee, "The frequency with which such associations are found engaged in practices which prevent the operations of a freely competitive economy, urges the necessity of more adequate regulation of their activities in the public interest."[13]

Legislation to Give the Antitrust Division the Power of Subpoena

As a means of expediting antitrust enforcement, numerous authorities propose that the Antitrust Division be given free access to the books and files of all companies operating in interstate commerce whenever the occasion demands. The Federal Trade Commission is authorized to require by *subpoena* all records relating to a particular investigation, but the Antitrust Division does not have this power. The word "subpoena" is a legal term (Latin: under penalty) which means a command to appear under penalty.

Most of the investigation work for the Antitrust Division is done by the FBI. This method of securing information has distinct limitations. Persons contacted by the FBI are not under oath in giving information, and frequently they do not tell the truth. Industry leaders, moreover, are becoming increasingly sophisticated. In many instances, they will neither talk to the FBI nor open their files for inspection. The only recourse which the Antitrust Division has in securing business records is to request them in grand jury proceedings. This is a time-consuming process, and frequently it is thwarted by legal technicalities.

The Need for a Standard on Corporate Size

In important sectors of the economy, we have seen, active, aboveboard price competition has been eliminated by the formation of mergers. At the present time, central financial units (holding companies) control the stock or assets of scores of formerly competing plants. These mergers have largely been built with impunity. They have been made possible in a legal way be-

[13] *Final Report and Recommendations of the Temporary National Economic Committee*, 77th Congress, first session, Senate Document 35, March 31, 1941, p. 38.

cause (1) the Supreme Court applied the Sherman Act to mergers in accordance with a so-called "rule of reason" and (2) it interpreted Section 7 of the Clayton Act to condemn only acquisitions of stock, not assets. As a result of these legal constructions, the United States Steel Corporation, for example, is now permitted to control some 30 percent of the total ingot capacity in the steel industry.

At present, the nation faces a paradox on the question of size. The Antimerger Act of 1950, we have seen, condemns the acquisition of stock or assets whenever the effect may be substantially to lessen competition. Upon the basis of this legislation, the proposed merger of Bethlehem Steel (having 15.4 percent of the total ingot capacity) and Youngstown (having 4.7 percent) was enjoined in 1958. Thus, a proposed merger having a control of some 20 percent of the ingot capacity is illegal, whereas the United States Steel Corporation having a control of 30 percent is legal.

It appears that neither the Department of Justice nor the courts are prepared to proceed in a positive way to remedy economic concentration. The problem is complex, and new legislation may be required to provide a clear-cut standard for use in dissolution proceedings. An alternative is to adopt a national law providing for federal incorporation of business concerns engaging in interstate commerce. As a condition for securing a federal charter, it could be stipulated that the petitioning company must comply with a specified standard on size (see also Chapter 17, pages 385–386). Basically, it is suggested that the rule on size should be one which calls for scrutiny of any size which threatens competition or which has anticompetitive effects.

In the opinion of many economists and legal authorities, the government must either (1) create and maintain numerous, independent business units and effective *price* competition; or (2) undertake directly to fix the prices controlled and managed by the large financial mergers. As we shall see in subsequent chapters, the alternative of extending regulation of the commission type to monopolistic mergers in industry does not promise to be practical or feasible. The fact is that thus far we have not developed satisfactory techniques for effective commission control on a large-scale basis. A substantial body of opinion and evidence points to the conclusion that if we are to avoid succumbing to monopoly power we must proceed to reduce the size of that power through an unraveling of the larger financial units created by merger.

Freedom of All to Buy or Sell

When plans for decentralizing industry are discussed, it is frequently declared that in numerous industries the government will not be able to create a condition of many sellers, because modern technology, product development, and marketing methods require large-scale units. The basic problem of oligopoly, it is said, will still remain. The proponents of competition reply that a reduction in the size of *supercorporations* can be made without

sacrificing business needs or efficiency. Very large business size has mainly been achieved by mergers of formerly competing companies, and in some way it will be possible to "spin off" or free these captive companies.

The proponents of competition point out, too, that competition in marketing can be promoted by a rule requiring large producers, controlling a substantial percentage of the output in their area of practical shipment, to sell to all comers offering to meet the publicly announced terms of sale. This rule would make possible the growth of new categories of dealers, merchants, and independent fabricators, who presently are unable to buy in adequate supply or at all (see also Chapter 9, pages 194–198, on refusal to sell).

F.O.B. Mill Pricing

Some legal and economic experts believe that the antitrust agencies should go further in the direction of requiring f.o.b. mill pricing, particularly in those industries in which freight costs are important and producing mills are geographically separated from each other.

F.o.b. mill prices continue to be used by many business enterprises, particularly in industries in which price competition operates effectively. In such instances, f.o.b. mill pricing is accepted as being eminently fair, just, and equitable. A seller secures a uniform profit margin on all shipments, regardless of their destination. Buyers, on the other hand, pay the exact freight costs and are free to choose their own methods and types of transportation.

F.o.b. mill prices, uniform to all buyers at the mill, develop naturally and automatically in a system of competitive markets. The need to require f.o.b. mill prices by law, it is reasoned, arises in the fact that in many industries (such as cement and beet sugar) the various mills are few in number and geographically separated from one another. The result is that each mill frequently has degrees of *local monopoly power* which it can exploit by charging nearby customers higher mill net prices than those located at distant points. If there is only one seller at a given place and *if he is allowed to discriminate*, it is practically certain that he will do so, for he can thereby make more profit. Section 2 of the Sherman Act condemns monopoly power; and in the application of this section it is reasoned that government has the duty and obligation to prohibit discrimination at the point of production which grows out of the presence of local monopoly power.

The Need for a Coordinated, Unified Antitrust Policy

The foregoing proposals, which bear directly upon the Sherman Act and its enforcement, do not, it should be noted, cover all the remedies which need to be applied to implement a policy of competition. There is general agreement that if we really want a competitive economy, it will be necessary to work toward a coordinated program on all fronts. Some of the proposals

made to implement the antitrust laws include the following: (1) a consideration of federal tax legislation which may operate to encourage mergers (e.g., the sale of a closely held corporation to take capital gains) or which serves to discourage the courts in ordering divestiture (e.g., the requirement that shareholders must pay a capital gains tax on the receipt of "divested stock"); (2) the adoption of a federal system of charters or licenses for corporations engaged interstate and foreign commerce; (3) a re-examination of the exemptions from the Sherman Act which have been granted to various industries and activities; (4) the reduction of tariff rates, especially in the case of those industries which are presently monopolistic (as evidenced by refusals to sell, identical bidding and the use of pricing formulas, the practice of export dumping, and local price cutting); (5) the control of large-scale advertising expenditures when the effect is substantially to lessen competition; and (6) the adoption of government grading to facilitate consumer choice and limit the power of sellers in charging prices which are out of line with objective standards.

POSITIVE RESULTS OF THE ANTITRUST PROGRAM

The frustrations and defeats of the prosecution in antitrust suits frequently cause students to overlook the beneficial effects of our antitrust program. Results are not what they might have been, but a considerable measure of competition has been preserved.

Since 1939, the Antitrust Division has initiated proceedings against scores of business enterprises, large and small. In cases against the following companies, selected to show the importance of many of the concerns involved, the government has secured a *favorable* court decision, providing for a penalty or for a modification of business organization or behavior. The companies include the A. B. Dick Co., Allied Chemical and Dye Corp., Aluminum Co. of America, American Brass Co., American Can Co., American Telephone and Telegraph Co., American Tobacco Co., American Optical Co., Bausch and Lomb Optical Co., Bethlehem Steel Co., Borden Co., Columbia Gas and Electric Corp., Continental Can Co., Corning Glass Works, Crown Zellerbach Corp., E. I. du Pont de Nemours, Diamond Match Co., Eastman Kodak Co., Eli Lilly and Co., Ethyl Gasoline Corp., General Electric Co., General Motors Corp., Goodyear Tire and Rubber, Great Atlantic and Pacific Tea Co., Johnson and Johnson, Kraft Cheese Co., International Business Machines, International Nickel of Canada, International Salt Co., Libbey-Owens-Ford Glass Co., Masonite Corp., Montgomery Ward, National Lead Co., Owens-Illinois Glass Co., Paramount Pictures, Proctor and Gamble Co., Pullman Co., Safeway Stores, Inc., Sears Roebuck, Sherwin-Williams Co., Socony-Vacuum Oil Co., Standard Oil Co. (Indiana), Standard Oil Co. of California, Standard Oil Co. (New Jersey), Texas Co., Timken Roller Bearing, United Fruit Co., United Shoe Machinery Corp.,

United States Gypsum, United States Pipe and Foundry Corp., United States Rubber Co., Univis Lens Co., Warner Bros., Westinghouse, and W. P. Fuller and Co.

As a result of antitrust prosecutions, American capitalism is very different from the capitalism which exists in western Europe. The Sherman Act has definitely served to eradicate and prevent open conspiracy and cartel arrangements. It has prevented and restrained flagrant competitive abuses. It stands also as a statue of liberty promising enterprisers the legal right to open business operations in fields of their own choice. Many American corporations make a sincere effort to comply fully with the policy of competition (see Figure 22). This is in sharp contrast to business policy in western Europe.

Swift & Company

UNION STOCK YARDS · CHICAGO 9, ILLINOIS

John Holmes
President

July 14, 1953.

Directors and Officers
Chicago Department Heads
Meat Packing Plant Managers
Branch House District Managers
Branch House Managers, including Panama and Puerto Rico
Dairy and Poultry Territory Managers
Dairy and Poultry Plant Managers
Ice Cream Plant Managers
Refinery Managers
Oil Mill Managers
Plant Food Managers
Technical Products Plant Manager
All District and Traveling Auditors
All Salesmen:

ANTI-TRUST LAWS

I desire to stress again that every employe is required to handle our business strictly in accordance with the law and that Swift & Company and its associated companies insist on careful and full compliance with all federal and state anti-trust laws. This is the responsibility and obligation of each employe.

VIOLATIONS NOT ONLY SUBJECT SWIFT & COMPANY TO SEVERE PENALTIES AND HEAVY EXPENSE OF LITIGATION BUT ALSO SERIOUSLY DAMAGE ITS REPUTATION.

EMPLOYES ARE ALSO INDIVIDUALLY AND PERSONALLY LIABLE AND ARE SUBJECT TO FINE OR IMPRISONMENT FOR VIOLATIONS TO WHICH THEY ARE A PARTY.

You must carefully observe federal and state anti-trust laws, and you are absolutely forbidden to enter into any agreement, combination, conspiracy, plan or scheme, or exchange of information, relating to or verging on price fixing, resale price maintenance (except under Fair Trade Acts on advice of General Counsel), limitation of production, division of territory, allotment of tonnage, or in any way in restraint of trade or designed to create a monopoly.

You are never to enter into any arrangement or combination, either personally or for Swift & Company, or any of its associated companies, either written or verbal, which would in any manner violate the foregoing.

Please acknowledge receipt.

FIGURE 22. Letter from the President of Swift & Company Admonishing Management to Observe the Antitrust Laws. (Permission of Swift & Company)

When price-fixing arrangements do exist in the United States, they are usually unstable, for the participants know that unity of action is illegal and nonenforceable. Price-fixing "rings" are continually being upset by certain sellers who break away. The common testimony of American business leaders is the difficulty of bringing and keeping rivals in line on price.

The Sherman Act also provides business firms with a means for protecting themselves against monopolistic abuses. As we have seen, any person injured by monopolistic activity may sue for threefold the damages sustained. Further, the Clayton Act (Section 16) enables a person to sue for a restraining order whenever he is threatened by a violation of the antitrust laws. These provisions provide a large measure of protection against coercion and predatory activity. The freedom which American business firms enjoy in introducing new technology, new processes, and new products—in comparison with those in western Europe—is undoubtedly to be explained in large part by the freedom of enterprise which the antitrust laws support.

The Sherman Act makes available a sound and practical remedy for the problem of economic concentration. It is true that dissolution proceedings have hardly been tried and that efforts to unravel centralized control have been inadequate. However, precedents for dissolution activity have been established, and greater efforts in this area await only the support of influential groups.

THE BASIC FACTORS WHICH SHAPE PUBLIC POLICY

In the final analysis, whether the Sherman Act is retained in full force and made more effective depends upon whether or not independent businessmen, and the people generally, want this sort of economic regulation. As Thurman Arnold has said, "Unfortunately, all antitrust law enforcement under any plan depends on the public attitude. It does not make much difference what your instrument for carrying out antitrust policy is, it will not be effective unless there is a strong demand."[14]

It is not likely that persons—in large or small enterprises—enjoying monopolistic arrangements will make a demand for vigorous antitrust law enforcement. Rather, the demand, if it is to grow, will have to come from independent businessmen, from farm and labor groups, and from the general public. The economic interest of the very large majority of the adult population—the voting electorate—lies in a policy of competition. Competition makes for innovation, progress, cheapness, and plenty, whereas monopoly leads to greater scarcity, high prices, and economic stagnation.

In the past, our economic organization has largely been formed and dictated by the interests of important economic groups. The problem of the present is whether these groups will continue to shape public policy or

[14] "The Antitrust Laws: A Symposium," *American Economic Review*, June, 1949, p. 690.

whether it will be shaped by the majority of the people. If it is to be the latter, there is the further question of whether the majority will demand (1) a policy of competition as embodied in the Sherman Act or (2) a policy of authoritarian control as expressed in over-all economic planning or social ownership. It is unlikely that the great majority of people will ever reason out an economic philosophy by their own efforts. Their thinking will rather be determined largely by their leaders. The policy of competition has an advantage in the political arena, for it is an integral part of our political, legal, and economic institutions. The American people, moreover, have a deep-seated suspicion of monopoly and economic concentration. In view of these facts, it is possible that some political leaders will increasingly turn their attention to a policy of making competition more effective.

Economic conditions are an important factor influencing public attitudes. If a prolonged business depression should develop before a policy of competition can be made more effective, it is possible that a majority of the people will demand a greater amount of direct government control and government ownership. The plan of having the government directly organize the use of resources has the advantage of being readily understood by the masses. A major problem faced by those desiring to make the policy of competition effective is that of devising ways to give the measures which must be adopted to implement the Sherman Act a high degree of political interest and popular appeal.

SUPPLEMENTARY ANTITRUST LEGISLATION OTHER THAN THE FEDERAL TRADE COMMISSION AND CLAYTON ACTS

1. The *Wilson Tariff Act* (1894), as amended by the act of February 12, 1913, 15 U.S.C. 8, is applicable to price fixing in the import trade. It declares that every combination, conspiracy, trust, agreement, or contract is illegal when it is intended to operate in restraint of trade or competition in the importation of goods from any foreign country into the United States. The penalties are similar to those of the Sherman Act.

2. The *Panama Canal Act* (1913), 15 U.S.C. 31, contains a provision stating that any vessel owned or operated by a concern which is doing business in violation of the antitrust laws shall not be permitted to pass through the Panama Canal. It does not appear that this provision has ever been enforced.

3. The *antidumping provisions of the Revenue Act of 1916*, 15 U.S.C. 72, contained in Title VIII ("Unfair Competition"), prohibit importing or selling imported articles at a price substantially less than the market price of the articles in the country of their production plus freight, duty, and other expenses incident to their importation into the United States, provided that such acts are done with an intent to injure an industry or the establishment of an industry in the United States. Penalties are similar to those of the Sherman Act.

4. The *unfair practices provisions* (section 303) *of the Tariff Act of 1930*, 19 U.S.C. 1337, stipulate that an import duty shall be placed on goods entering the United States equal to the net amount of any bounty or subsidy which is granted in the country of production or export by government or by any person, partnership, association, cartel, or corporation.

11

The Exemption of Particular Industries and Activities from the Antitrust Laws

The Sherman Act, as well as supplementary antitrust legislation, we have noted, is applicable in principle to all forms of private business carried on in interstate and foreign commerce. The Sherman Act itself makes no exception and declares that *every* restraint of trade and commerce is unlawful. In giving effect to the antitrust statutes, the Department of Justice has sought to preserve and maintain the institutions of free enterprise and price competition in all lines of business not given over to public price control by commissions.

THE GRANTING OF EXEMPTIONS

Various business groups, from earliest times, have found an economic advantage in acting in unison in the sale of goods. In some cases, the desire for collective action stems from the anarchic and chaotic conditions of price-making which develop when business rivalry is carried on without public rules or regulations. In other cases, the desire arises in the belief that a group is being disadvantaged by monopolistic action on the part of another industry group. On all occasions, however, experience shows that there is also a strong and continuing desire on the part of the members of such groups to avoid price competition with each other, even competition which is fair and aboveboard.

Since concerted action on price is unlawful under the Sherman Act, politically important or economically powerful groups, bent on pursuing their commercial advantage, find that they must either openly violate the law or take steps to have Congress change the law in its application to them. The first alternative is not a satisfactory one, for there is always the possibility of criminal suits and the disgrace of criminal convictions. Moreover, since the

members of such business groups are typically well established in the community and active in social and civic affairs, there is a strong desire to be law-abiding and law-observing. The practical alternative, therefore, from their point of view is to have the law changed.

The attitude of big business with respect to getting what it wants in matters of public policy is clearly revealed in a statement made by Mr. Irving S. Olds, chairman of the United States Steel Corporation, in connection with the decision of the Supreme Court in the Cement case (1948) outlawing the use of the basing-point plan of delivered prices. Instead of indicating a willingness to comply with the law, Mr. Olds frankly stated that industry is "faced with two alternatives—either to seek remedial legislation or to educate the Supreme Court."[1]

In the following sections, consideration will be given to the principal industries or activities which are exempt from the federal antitrust laws. The areas now excluded, in whole or in part, consist of (1) labor unions (1914 and subsequently by judicial decision); (2) agricultural coöperative marketing associations (1914 and 1922); (3) water carriers in foreign and domestic commerce (1916); (4) business associations in export trade (1918); (5) companies cooperating in defense production (1950); (6) handlers of agricultural products who make marketing agreements with the Secretary of Agriculture (1933 and 1937); (7) associations of aquatic producers (1934); (8) manufacturers and handlers of hog-cholera serum and hog-cholera virus (1935); (9) sellers of trademarked products using resale price-maintenance contracts (1937); (10) air carriers (1938); (11) telegraph companies (1943); (12) associations of insurance companies (1920 and 1945); (13) railroads and other surface carriers (1948); and (14) production control in petroleum (conducted by state action).

LABOR AND AGRICULTURAL ORGANIZATIONS

Section 6 of the Clayton Act (1914) provides: "Nothing contained in the anti-trust laws shall be construed to forbid the existence and operation of *labor, agricultural, or horticultural organizations, instituted for the purposes of mutual help, and not having capital stock or conducted for profits*, or to forbid or restrain individual members of such organizations, from carrying out *the legitimate objects thereof;* nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade under the anti-trust laws."[2]

In addition, Section 20 states: "No restraining order or injunction shall be granted by any court of the United States . . . in any case between an employer and employees, or between employers and employees . . . involving,

[1] *Journal of Commerce*, April 28, 1948.
[2] 15 U.S.C. 17. Italics supplied.

or growing out of, a dispute concerning terms or conditions of employment, unless necessary to prevent irreparable injury to property . . ."[3]

Background for Section 6 of the Clayton Act

There is general agreement that the object of Section 6 of the Clayton Act was to clarify the law with respect to the *legal status* of labor, agricultural, and horticultural associations. Samuel Gompers, president of the American Federation of Labor, in particular, contended before the House committee considering new antitrust legislation that "under the interpretation placed upon the Sherman Antitrust Law by the courts, it is within the province and within the power of any administration at any time to begin proceedings to dissolve any organization of labor in the United States. We do not want to exist as a matter of sufferance, subject to the whims or to the chances or to the vindictiveness of any administration or of an administration officer."[4]

The policy of concerted action by labor groups—as well as by groups of farmers—was coming to be accepted by the general public, and sufficient support was found in Congress to provide that unions and agricultural cooperatives are not in themselves violative of the antitrust laws. Many years of experience in the field of labor relations had convinced various public leaders that collective action by labor is necessary to offset the superior bargaining power of large industrial corporations. Individual workers are urgent sellers, invariably in need of ready cash. They have little knowledge of market forces, and their skill at bargaining is usually inferior to that of an employer. There are also few workers who are indispensable to an employer, whereas the loss of a job is usually of great importance to a worker. Not infrequently, moreover, employers themselves act in unison in wage negotiations and in deciding upon the maximum rates which they will pay within a given community. For these reasons, in particular, it has been found socially desirable to strengthen the bargaining position of labor in order to make it more certain that wages will reflect the value contribution made by labor.

Section 20 of the Clayton Act and the Economic Weapons of Trade Unions

The desire of the unions as expressed in Section 20 was to curb the unrestricted use of injunctions by the federal courts to restrain picketing, persuasion, boycotting, and "conspiring to quit," as well as the activity of union officials in calling strikes. On its face, Section 20 purported to immunize strikes, picketing, and boycotting from injunctions or restraining orders issued by a federal court. It was also generally believed that Section

[3] 29 U.S.C. 52.

[4] *Anti-Trust Legislation*, Committee on the Judiciary, 63rd Congress, second session, House Report 627, May 6, 1914, p. 15.

20 went further and actually legalized the traditional trade union weapons of economic force.

The interpretation and application of Section 20 by the courts, however, soon revealed that they were unwilling to restrict in any greatly significant way the granting of labor injunctions. In *Duplex* v. *Deering*, the Supreme Court considered business activity to be a "property right," and held that an employer's business could not be hindered by pressures exerted by union members who were not employees of the plant directly involved in the strike.[5] Section 20, the Court held, restricted the use of the injunction only in favor of those concerned as parties in the dispute.

It is generally agreed by labor economists that the "hostility" of the judges toward the plain intention of Congress to accept labor unions and their traditional devices for exerting economic force finally led to the adoption of the Norris-LaGuardia Act in 1932. This act took away from the federal courts the power to issue injunctions in labor disputes, except in cases of fraud or violence. In the Wagner Act of 1935, Congress further strengthened the position of labor by giving workers the legal right to organize and bargain collectively and by requiring employers to bargain with unions duly established by majority vote.

The Hutcheson Case and the Further Exemption of Unions from the Sherman Act

In the Hutcheson case (1941), Professor Edward S. Corwin observes, the Court "largely released labor combinations from the control of the Sherman Act, a result which was attained by a singularly bold exercise of the power of statutory construction."[6] Briefly, the majority of the Court in the Hutcheson case held that if a labor union does not combine or conspire with an employer group it may engage largely in any sort of activity which promotes its interest. Justice Frankfurter, speaking for the Court, declared: "So long as a union acts in its self-interest and does not combine with non-labor groups, the licit and the illicit . . . are not to be distinguished by any judgment regarding the wisdom or unwisdom, the rightness or wrongness, the selfishness or unselfishness of the end of which the particular union activities are the means." In no case, however, the Court emphasized, is a union privileged to join with a business group to injure the trade of other business firms or to fix product prices.[7]

Subsequently, in the Allen Bradley case, the Court again held that a labor union could not combine with employers to restrain competition in the sale of merchandise. This rule, the Court observed, follows logically, for otherwise the prohibition on price fixing and restraint of trade by business groups

[5] 254 U.S. 443 (1921).

[6] E. S. Corwin, *The Constitution and What It Means Today* (Princeton, 1941), pp. vii–viii.

[7] 312 U.S. 219, 231-232 (1941).

would be emasculated. In the words of Justice Black, "The primary objective of all the anti-trust legislation has been to preserve business competition and to proscribe business monopoly. . . . If business groups, by combining with labor unions, can fix prices and divide up markets, it was little more than a futile gesture for Congress to prohibit price-fixing by business groups themselves."[8]

Thus it is that we have the ideal of competition in business, on the one hand, and that of collective action in labor relations, on the other hand.

The Acceptance of Agricultural Cooperatives

The conditions which exist in the sale of labor services are also frequently found in the sale of farm products. Local dealers are few in number, and processors of farm products are usually organized in large corporate units. As a result, farmers in many cases have little or no active buying competition for their products. In order to strengthen their bargaining position, Congress likewise found it to be sound public policy to permit the formation of associations of farmers organized as cooperatives. Under this legislation farmers may legally join hands in the cooperative marketing of their own commodities.

A cooperative *marketing* association may be defined as a group of producers working together to sell their products without competing against one another (see also Glossary of Terms at the end of Chapter 5). The arrangement usually provides for equal voting power for each member and for a sharing of the revenue in accordance with the amount and quality of products sold by each member through the association. In order to provide for a centralized economic control, it is usual for the association to make a "marketing contract" which provides that the members will sell their products only through the association.

COMMON CARRIERS BY WATER IN FOREIGN COMMERCE, IN INTERSTATE COMMERCE ON THE HIGH SEAS, OR ON THE GREAT LAKES

The Shipping Act of 1916, as amended, provides that every common carrier by water in foreign commerce, in interstate commerce on the high seas, or on the Great Lakes, as well as any persons engaged in forwarding or furnishing wharfage, dock, warehouse, or other terminal facilities in connection with a common carrier by water, shall immediately file a copy *of all agreements* with another carrier or person subject to the act with respect to rates, fares, charges, and other cooperative arrangements. All such agreements, if approved by the Maritime Board, it is provided, shall be exempt

[8] 325 U.S. 797 (1945).

from the federal antitrust laws, including suits for threefold damages by persons injured by monopolistic practices.[9]

The reasons which Congress had for granting shipping lines an exemption from the antitrust laws were explained by the House committee as follows:

> It is the almost universal practice for steamship lines engaging in the American foreign trade to operate, both on the inbound and outbound voyages, under the terms of written agreements, conference arrangements or gentlemen's understandings, which have for their principal purpose the regulation of competition through either (1) the fixing or regulation of rates; (2) the apportionment of traffic . . . ; (3) the pooling of earnings from all or a portion of the traffic; or (4) meeting the competition of non-conference lines . . .
>
> Moreover, steamship agreements and conferences are not confined to the lines engaging in the foreign trade of the United States. They are as universally used in the foreign trade of other countries as in our own. The merchants of these countries now enjoy the foregoing advantages of co-operative arrangements, and to restore open and cutthroat competition among the lines serving the United States would place American exporters at a disadvantage in many markets as compared with their foreign competitors.[10]

Various groups of American exporters and consignees also supported the proposal to legalize the making of rate agreements by the conference method on the ground that formal rate schedules would make for stability in their operations. Cutthroat and discriminatory competition, they reported, served to disrupt their business negotiations. The actual consummation of a business transaction in foreign trade may take weeks or months; and during this period exporters like to have stable freight rates, if possible, so that foreign buyers can know what their delivered costs will be.

Functions of the Federal Maritime Board

The Shipping Act of 1916, in granting exemptions, also made provision for a regulatory commission to supervise common carriers by water operating in foreign commerce, in interstate commerce, or on the Great Lakes. This commission is now designated the Federal Maritime Board (see Tables 1 and 2, pages 46–47).

The Federal Maritime Board (1) regulates rates and services of American and foreign flag carriers engaged in the foreign commerce of the United States; (2) regulates practices of persons engaged in forwarding or furnishing wharfage, dock, warehouse, or other terminal facilities used in connection with common carriers by water; (3) passes upon agreements made by water carriers, terminal operators, or freight forwarders with respect to rates and trade practices; (4) protects shippers and ports against unfair and

[9] 46 U.S.C. 801, 814.

[10] *Report on Creating a Shipping Board*, Committee on the Merchant Marine and Fisheries, 64th Congress, first session, House Report 659, May 9, 1916, pp. 27–28.

discriminatory practices; and (5) determines and awards subsidies to place United States shipbuilding and ship operation on a parity with foreign construction and operation.

The Federal Maritime Board also regulates offshore common carriers which serve our territories and possessions and the new states of Alaska and Hawaii. The authority it exercises over such carriers is considerably more rigid than the authority it has over carriers in foreign commerce. Regulation of carriers by water engaged in interstate (domestic) commerce on the high seas and on the Great Lakes was transferred to the Interstate Commerce Commission in 1940, and this latter agency now exercises jurisdiction over water carriers operating along and between the coasts, and upon inland waters of the United States.

In the actual making of foreign shipping rates, practically all the American flag carriers operating in a certain area—such as the Pacific coast and the Orient—join with the foreign flag carriers also operating in that area, to bind themselves into a rate-making conference. Each company agrees to abide by the rates which are established by a majority or some other percentage vote. All the rates agreed upon by a conference of carriers touching United States ports must be filed with the Maritime Board and also are kept open for public inspection at the offices of the conference and the carriers. The Maritime Board does not specifically approve rates, but all rates are subject to disapproval by the Board to the extent that they may be unfair or unjustly discriminatory or detrimental to the commerce of the United States.

EXPORT TRADE

The Export Trade Act—the "Webb-Pomerene Law" (1918)—provides in Section 2 that nothing contained in the Sherman Act "shall be construed as declaring to be illegal an association entered into for the sole purpose of engaging in export trade and actually engaged solely in such export trade, or an agreement made or act done in the course of export trade by such association, *provided* such association, agreement, or act is not in restraint of trade within the United States, and is not in restraint of the export trade of any domestic competitor of such association."[11]

At the present time, some thirty-four export associations are in active operation under the terms of the Webb-Pomerene Act. Products sold abroad by the various "Webb associations" include motion picture films, tires, tools, coal, dried fruit, carbon black, lumber, abrasives, electrical equipment, screws, evaporated milk, machines, pencils, potash, rubber products, rice, sulphur, textiles, and vegetable oil. Export associations typically concern themselves with price fixing and sales allocation. Actual business transactions are usually carried on by members in their own sales organization.

[11] 15 U.S.C. 62.

Each association is required to file copies of its organizational papers with the Federal Trade Commission and make periodic reports of its activities. The Commission, in turn, has the function of seeing that the agreements are on file and of studying the reports and activities of the associations to determine whether or not they are in accordance with the law. If the Commission believes that violations exist, it makes an investigation and issues a recommendation for modification, if such is warranted by the facts. The Export Trade Act, however, has no "teeth" in it, and the Commission has no authority to require compliance. It can, however, refer its findings and recommendations to the Department of Justice for appropriate action. The Department of Justice itself, without specific direction by the Commission, may also initiate prosecutions.

Forces Leading to the Enactment of the Webb-Pomerene Act

The moving force, or interest group, which initiated the demand for a relaxation of the Sherman Act as applied to domestic exporters appears to have been the large copper producers. Thus, in 1940 Mr. Cornelius Kelley, president of the Anaconda Copper Mining Company, testified before the TNEC that as early as the Taft administration (1908–1912) he had sought to secure Congressional approval of "the proposition that the restrictions of our antitrust Act should be so modified as to enable exporters, not only of copper, but of all products, to combine in order to match the combined buying power that they were up against on the other side"—namely, the cartels and monopolistic buying groups in Europe. "The result," Mr. Kelley stated, "was an agitation that finally resulted in the passage of the so-called Webb-Pomerene Act."[12]

Webb Associations and Foreign Cartels

During the debates on the Webb-Pomerene Act, fears were expressed by various members of Congress that domestic exporters would use the law to form cartel agreements with foreign combinations. Senator Pomerene resolutely stated, however, that American firms would not be privileged to join hands with foreign cartels. The Sherman Act, he declared, is still the basic law of the land.

Soon after the act of 1918 was passed, however, various export associations began to make alliances with foreign cartels; and in 1946 it was reported that some fifteen associations had actually made agreements with foreign producers at one time or another.[13] Many of these agreements contained provi-

[12] *Cartels*, Hearings Before the Temporary National Economic Committee, 76th Congress, third session, Part 25, 1940, p. 13113.

[13] *Small Business and the Webb-Pomerene Act,* 79th Congress, second session, Senate Subcommittee Print 11, 1946, pp. 14–15.

sions which restricted price competition in international markets, divided sales areas, and placed restraints on potential competitors.

The position of the Federal Trade Commission for a long time was that agreements between Webb associations and foreign competitors were not objectionable if they did not affect the import trade or the domestic commerce of the United States. In a letter to domestic silver producers, July 31, 1924, the Commission stated: "The purpose of the act seems to have been to provide a method for eliminating competition in foreign markets among domestic producers. . . . There seems to be no reason why a Webb-Pomerene association composed of nationals or residents of the United States and actually exporting from the United States, might not adopt a trade arrangement with non-nationals reaching the same market, providing this market was not the domestic market of the United States and the action of this organization did not reflect unlawfully upon domestic conditions.[14]

In 1955, a case arose where an association of exporters exchanged with their chief foreign competitor information as to their prices and those of their chief foreign competitor. The exchange occurred before the member-exporters' prices were finally published, and the result was that when the United States exporters' and their foreign competitor's prices came out, they were uniform to a high degree in countries outside the United States. The Commission declared such conduct not to be "in the course of export trade" and therefore not entitled to the benefit of the Webb law.[15]

The View That the Webb-Pomerene Act Is Incompatible with American Policy and Should Be Repealed

About one-half of the Webb associations, the records show, are found in industries dominated by three or four companies (oligopoly). According to the Department of Justice, such associations usually have had a long history of antitrust litigation and have engaged in patent-control programs, market sharing, and basing-point pricing. The Webb-Pomerene privilege, it thus appears, is frequently desired and used as an additional device for strengthening monopolistic control.

Many eminent economists and statesmen believe that the Webb-Pomerene Act should be repealed. The main reasons advanced for this belief are the following: (1) the legislation provides a mechanism for fixing domestic prices, (2) the act is at times chiefly used by large corporations to strengthen their dominant bargaining power, and (3) the law stands as a damaging deviation to our domestic policy of competition and our declared international position of eliminating all cartels and cartel-like structures. In international

[14] *Export Prices and Export Cartels*, Temporary National Economic Committee, Monograph 6, 1940, p. 127.

[15] *FTC Export Trade Association Bulletin No. 1-55*, July 15, 1955, published in Commerce Clearing House Trade Regulation Service, 10th Edition, Paragraph 5335.99.

discussions on cartels our official policy is weakened by the very existence of the Webb-Pomerene Act, and we are thereby prevented from prevailing upon other countries to move a little closer to our traditional position.

A number of congressmen agree that repeal is the proper policy to adopt towards the Webb-Pomerene Act. They emphasize, however, that political support for repeal would be difficult to obtain because of the opposing strength of big business. In the words of Congressman Multer (New York), "I do not think we could repeal it. I do not think you could get enough of the Congress to vote for repeal of it with all of the pressures of the large companies that are now getting these advantages under the Webb-Pomerene Act."[16]

ASSOCIATIONS OF PRODUCERS OF AGRICULTURAL PRODUCTS

The Capper-Volstead Act (1922), "an act to authorize association of producers of agricultural products," provides that

> Persons engaged in the production of agricultural products *as farmers, planters, ranchmen, dairymen, nut, or fruit growers*, may act together in associations, *corporate or otherwise, with or without capital stock*, in collectively processing, preparing for market, handling, and marketing *in interstate and foreign commerce*, such products of persons so engaged. *Such associations may have marketing agencies in common;* and such associations and their members may make the necessary contracts and agreements to effect such purposes. . . . If the Secretary of Agriculture shall have reason to believe that any such association monopolizes or restrains trade in interstate or foreign commerce *to such an extent* that the price of any agricultural product is unduly enhanced by reason thereof, he shall serve upon such association a complaint.[17]

Reasons for the Enactment of the Capper-Volstead Act

The Clayton Act (1914), we have seen, gave farmers the assurance that agricultural cooperative associations are not in themselves violative of the antitrust laws, provided they are operated for mutual help, have no capital stock, and are not conducted for profit. Following the enactment of this legislation, there developed much uncertainty with regard to the action which a cooperative might take to influence prices. The Clayton Act legalized the *existence* of agricultural cooperative associations, and presumably

[16] Hearings Before the Subcommittee on Study of Monopoly Power, Committee on the Judiciary, House of Representatives, Serial 14, Part 3, 81st Congress, second session, 1950, p. 97.

[17] 7 U.S.C. 291, 292. Italics supplied.

the antitrust laws still applied to their *activities*. The Clayton Act, moreover, gave legal status only to associations "not having capital stock," and increasingly agricultural marketing associations were coming to find advantages in the corporate form of organization.

Interested farm groups, accordingly, sought legislation in Congress (1) declaring that the formation of an *incorporated* cooperative association having capital stock is not in itself in violation of the antitrust laws and (2) legalizing *concerted action* by the members of a cooperative marketing association *to enhance the prices of their products.*

The Capper-Volstead Act does not create or authorize the creation of cooperative marketing associations. All such associations are formed under the laws of the various states; and in general it may be said that a group of persons cannot act as a marketing association *under the name of a cooperative* unless they are duly organized under the cooperative law of a state. The basic purpose of the Capper-Volstead Act is to provide that "farmers" acting together in associations—"corporate or otherwise"—for processing and marketing products in *interstate* commerce, may act in unison to affect the prices of their commodities.

The important favors now granted to the cooperative marketing associations are (1) an authorization to organize and (2) the privilege of acting in concert with respect to prices, so long as the price of any agricultural product is not *unduly enhanced by reason thereof*. The authority to scrutinize prices is placed in the hands of the Department of Agriculture rather than in the Department of Justice. If the Secretary of Agriculture believes that monopoly power is being exercised to such a degree that the price of an agricultural product is unduly enhanced, he is empowered to issue a complaint. If, after a hearing, the Secretary finds that the complaint is justified, he is directed to issue a cease-and-desist order. No penalties are provided; but if the association does not comply, provision is made for the Attorney General to take appropriate steps in a federal district court to secure compliance.

At the present time, agricultural cooperatives are an important factor in the American economy. Almost 10,000 agricultural cooperatives are actively engaged in marketing farm products (see Table 20). The membership consists of more than 7,500,000 farmers. In 1958, the total gross volume of business handled by these associations was $13.5 billion.[18] Marketing cooperatives, generally, also purchase supplies for their members.

The Exercise of Monopoly Power by Agricultural Marketing Associations

The Capper-Volstead Act, it may be said, provides agricultural producers with a substantial exemption from the antitrust laws. A single cooperative

[18] A. L. Gessner, "Coöperative Dollar Volume Up," *News for Farmer Cooperatives*, United States Department of Agriculture, April, 1959, p. 2.

association may enter into contracts with scores of farmers which require them to market their products only through the association. Two or more associations, complying with the act, it is also provided, "may have marketing agencies in common." Thereupon, the price of a particular agricultural product, the law recognizes, may be influenced by an association so long as it is not "unduly enhanced." What limitation on the making of price increases is imposed by this provision? The law establishes no standard except the "opinion" of the Secretary of Agriculture.

TABLE 20. Number of Farmers' Marketing, Farm Supply, and Related Service Cooperatives, 1956–1957

Commodity Group	Number of Local Associations	Number of Regional Associations	Total
Beans and peas (dry edible)	6	9	15
Cotton and products	538	28	566
Dairy products	1480	264[a]	1744
Fruits and vegetables	651	74[b]	725
Grain, soybeans, soybean meal and oil[c]	2092	27	2119
Livestock and products	460	41	501
Nuts	30	6	36
Poultry products	129	18	147
Rice	54	6	60
Sugar products	—	66[d]	66
Tobacco	—	35	35
Wool and mohair	158	25	183
Miscellaneous	66	4	70
Total marketing	5664	603	6267
Farm supply	3254	117	3371
Service	229	5	234
Total marketing, farm supply, and related service	9147	725	9872

[a] Includes 207 bargaining cooperatives
[b] Includes 15 bargaining cooperatives
[c] Includes soybean marketing and processing cooperatives
[d] Includes 47 sugar beet bargaining cooperatives
SOURCE: A. L. Gessner, *Statistics of Farmer Cooperatives*, United States Department of Agriculture, Washington, D.C., June, 1959

It should be noted that the Capper-Volstead Act does not completely exempt the marketing activity of farmers' cooperatives from the operation of the antitrust laws. In the Borden case (1939), the Supreme Court held that an agricultural cooperative cannot join with "other persons"—such as dealers, distributors, or labor unions—to fix prices or restrain trade. The Borden case involved the legality of the price-fixing activities of a milk marketing cooperative. This association, it was found, had entered into a conspiracy "with

major distributors and their allied groups, with labor officials, municipal officials, and others, in order to maintain artificial and non-competitive prices to be paid to all producers for all fluid milk produced in Illinois and neighboring states and marketed in the Chicago area." In declaring this agreement of a cooperative with "other persons" to be an illegal restraint, the Court declared: "The right of these agricultural producers thus to unite in preparing for market and in marketing their products, and to make the contracts which are necessary for that collaboration, *cannot be deemed to authorize any combination or conspiracy with other persons* in restraint of trade that these producers may see fit to devise."[19]

If two or more cooperatives join hands to fix prices, however, it appears that their joint action is exempt from the antitrust laws. Thus, in the Maryland Cooperative Milk Producers case (1956), a District court held that under Section 6 of the Clayton Act "farmers and farmers' cooperatives became a favorite of the law, in a sense. They were granted an express exemption and received a special dispensation from the antitrust laws. They may lawfully combine with impunity and may legally agree to fix prices on their products."[20] This is the first case in which a court has passed on this specific issue, and the conclusion may not be upheld in subsequent cases.

It appears that members of an agricultural cooperative are not privileged to undertake by agreement any action *to limit the production of crops or to destroy crops.* In 1951, for example, the Antitrust Division brought action against an association of lettuce growers in California, charging an agreement to reduce the amount of lettuce produced by destroying supplies during the peak of the harvest season. The government was granted an injunction restraining the defendants from destroying the lettuce crop in accordance with any agreement, and the decision was subsequently affirmed by the Supreme Court.[21]

Cooperatives commonly raise prices by withholding supplies and by excluding from sale certain portions of the whole supply. Such "surpluses" are sometimes sold abroad at low prices (export dumping), converted into specialty products (such as the use of almonds for almond butter and oil), diverted into lower-order uses (such as the use of dried prunes and raisins for livestock feed), or destroyed. Members of a cooperative association, we have seen, cannot legally take private action by agreement to limit crop production by destroying supplies. Under the various state and federal marketing agreement programs, however, handlers (dealers), including cooperatives, appear to be privileged to dispose of "surpluses" as they desire (see below, pages 244–247). The federal government itself, moreover, may engage in crop limitation activity under the parity-price legislation (see Chapter 20, pages 438–439).

[19] *U.S.* v. *Borden Co.*, 308 U.S. 188, 205–206 (1939). Italics supplied.

[20] *U.S.* v. *Maryland Cooperative Milk Producers*, 145 F. Supp. 151 (1956).

[21] *U.S.* v. *Grower-Shipper Vegetable Assn. of California*, 344 U.S. 901 (1952).

ANTITRUST EXEMPTIONS GRANTED DURING NATIONAL EMERGENCIES

Suspension of the Federal Antitrust Laws with Respect to All Business During the Great Depression (1933–1935)

Section 5 of the National Industrial Recovery Act (NIRA), 48 Stat. L. 195 (1933), provided that "while this title is in effect and for 60 days thereafter, any code, agreement, or license approved, prescribed, or issued and in effect under this title . . . shall be exempt from the provisions of the antitrust laws of the United States."

The impact of the great depression which began in 1929 brought many demands from business leaders for a modification or suspension of the federal antitrust laws. A business depression stimulates the operation of price competition, for individual sellers seek to find a selling outlet for supplies which do not move at the established prices. During the course of the depression, big business—which had grown very much bigger as a result of the mergers of 1920–1929—accordingly found that the remaining independent sellers were reducing their asking prices in order to be able to deal. That was real competition. Big business, however, being burdened with heavy fixed costs, did not want price competition. In its eyes, a competitor on price was a "chiseler."

The complaint of big business against the antitrust laws was not that they were being too vigorously enforced. Enforcement activity, in fact, was largely nonexistent. Rather, the complaint arose because big business could not openly and legally take steps to fix prices and curb production. Many plans were presented by the leaders of big business for the "self-government" of industry. In an effort to make such plans tempting to the public, it was also proposed that government and business cooperate in providing minimum wages, shorter hours, an abolition of child labor, and various kinds of social insurance.

The theory sponsored by the advocates of NIRA—who were not college professors, as popularly believed, but leaders of big business and organized labor—was that the Sherman Act imposed and made necessary the "ruthless competition" which was giving consumers bargains at the expense of labor and capital. If prices could be raised by legalized monopoly action, it was claimed, wages could be raised, and the larger purchasing power would hasten prosperity. This view, however, as many economists then indicated, was- and is—illusory. If higher wages and profits are secured by *some* industries—such as coal—consumers generally are required to turn over more of their income to the favored producers for the same or fewer goods. The process is simply one of transferring income from one group to another. Moreover, if costs and prices of *all* products are simultaneously increased by the same percentage, the gains in total purchasing power will be offset by

the loss in total purchasing power occasioned by the high prices. There is no magic in price-cost raising experiments to bring back prosperity.

In accordance with the procedure established in the act, trade associations were invited to draw up "codes of fair competition" and present them to the National Recovery Administration (NRA) for approval. After being approved by the NRA and signed by the President, the codes became law. Although the act contained a provision that the codes should not permit monopoly or monopolistic practices, this proviso was openly violated and ignored. Nearly fifty of the codes filed by the major industries and given public approval contained price-fixing provisions which were managed by the industries themselves. Such codes, it has been said, were actually codes of "no-competition" or of "monopolistic limitation of competition."[22]

Price increases under the NRA program were universal, and consumer protests became widespread and vehement. President Roosevelt, who sponsored NIRA "as the most important and far-reaching legislation ever enacted by Congress," subsequently came to regard the relaxation of the antitrust laws as a most serious error which should be speedily remedied. Finally, on May 27, 1935, the Supreme Court held the act to be unconstitutional in the Schechter Poultry case, largely on the ground that the violations charged under the Poultry Code were concerned with local business which had only an "indirect" effect upon interstate commerce and which consequently were beyond the scope of national power.[23] The decision of the Court was widely acclaimed by the people; and many shared the feeling of Senator King of Utah, who declared: "Thank God for the Supreme Court."

The Antitrust Laws and Economic Recovery. What policy should the United States pursue with respect to the antitrust laws during a period of business depression? There is widespread agreement among economists that what is needed to bring high-level employment and production is *rising consumers' demand*. How can a greater consumers' demand be called forth? At this point, differences of opinion develop, but a considerable number of economists emphasize that a policy of artificially raising prices operates to check demand and restrict employment. Many urge, therefore, that the antitrust laws be vigorously enforced during a period of depression. Thus, in 1932, in the midst of the great depression, 127 leading economists, affiliated with 43 universities in 24 states, sent a memorandum to the resolutions committee of each political party urging a vigorous enforcement of the antitrust laws. In particular, these economists advocated a

Rejection of the assertion made by those seeking to break down the Sherman Act, that it makes necessary the development of excessive capacity

[22] Edward S. Mason, "The Report of the President's Committtee on the NRA," *Quarterly Journal of Economics*, May, 1937, p. 548.

[23] *Schechter Bros. v. U.S.*, 295 U.S. 495 (1935). See also Edward S. Corwin, "The Schechter Case – Landmark or What?" *New York University Law Quarterly Review*, January, 1936, pp. 151–190.

and wasteful over-production, and the equally false assertion that this was one of the causes of the present industrial depression. On the contrary, the most competent economic opinion, as well in Europe as in this country, can be cited in support of the view that a strong contributing cause of the unparalleled severity of the present depression was the greatly increased extent of monopolistic control of commodity prices which stimulated financial speculation in the security markets. There is growing doubt whether the capitalistic system, whose basic assumption is free markets and a free price system, can continue to work with an ever widening range of prices fixed or manipulated by monopolies.[24]

Economists rarely urge direct wage reductions, but they do recommend cost reductions through increased efficiency. The economic error involved in a plan of making artificial wage increases to stimulate recovery is well expressed by Dr. Jacob Viner as follows:

> Wages, as we have seen, are both costs and incomes. As costs, they certainly are obstacles to employment; as income, they certainly are a stimulus to employment. They have that ambivalent role, and we must always remain aware of it. It seems to me, however, that discussion sometimes overlooks the distinction between wage rates per person per hour or per day and the size of the payroll. Any measure which guarantees an increase in the payroll at a time of unemployment is sure to promote either fuller employment or inflation or a mixture of both. But it doesn't necessarily follow (and I think many economists have taken that step without further argument) that any increase of wage rates will have the same consequences. An increase of wage rates may quite conceivably reduce the payroll.[25]

If and when a severe depression again occurs, it is likely that organized business and large corporations will make new efforts to gain a general suspension of the antitrust laws. Our experience with the NRA, however, shows clearly that this policy retards recovery.

Certificates of Immunity Against Antitrust Prosecution Granted to Business Enterprisers in Wartime Production

Section 12 of the Small Business Mobilization Act (1942), 56 Stat. 357, provided that "whenever the Chairman of the War Production Board shall, after consultation with the Attorney General, find, and so certify to the Attorney General in writing, *that the doing of any act or thing, or the omission to do any act or thing, by one or more persons* . . . is requisite to the prosecution of the war, such act, thing, or omission shall be deemed in the public interest and no prosecution or civil action shall be commenced with

[24] "Economists' Committee on Antitrust Law Policy," *American Economic Review*, September, 1932, pp. 465–469.

[25] Jacob Viner, "The Role of Costs in a System of Economic Liberalism," *Wage Determination and the Economics of Liberalism* (Washington, 1947), p. 32.

reference thereto under the antitrust laws of the United States or the Federal Trade Commission Act. . . . This section shall remain in force until six months after the termination of the present war" (italics supplied).

During the course of the war, more than 200 certificates of immunity were granted to various groups of business enterprisers—in big business firms as well as in small ones. The certificates granted stated simply a recommendation for joint action—such as joint action for "transporting petroleum," "the production of certain naval equipment," "penicillin production," "the marketing of petroleum," "General Electric and Westinghouse Co."—and provided that the doing of any act with reference thereto was requisite to the prosecution of the war.

It is important to note that the activity immunized was "any act or thing" done by one or more persons engaged in wartime production which would be considered to be illegal under the antitrust laws. Such acts could include price fixing, a division of sales territory, a restriction of production, or the elimination of competitors. In effect, the grant of immunity was in the nature of a grant of pardon for any illegal act—civil or criminal—which a person or persons might do in connection with joint action in the war effort. In no way was the immunity restricted to the doing of a specific directive issued by the WPB.

Antitrust Exemption Since 1950

Section 708 of the Defense Production Act (1950), as amended, authorizes the President to consult with representatives of industry, business, finance, agriculture, and labor on the making of voluntary agreements to further defense mobilization. No act requested by the President, the law provides, in pursuance to such a voluntary agreement, shall be construed as being within the prohibitions of the antitrust laws or the Federal Trade Commission Act. Provision is made for the Department of Justice and the Federal Trade Commission to scrutinize the requests and agreements. Approval by the Attorney General is also required before the exemptions can become effective.

The Act, including Section 708, has been extended periodically since its enactment in 1950. Inasmuch as world tensions are likely to persist, it is probable that Congress will continue to renew the exemption.

There have been over fifty agreements approved under Section 708, and in 1960 there were some nineteen in effect. About one-half of these are in a stand-by status pending reactivation in time of emergency. The number of members in the active committees (or agreements) who have immunity under the antitrust laws and the Federal Trade Commission Act for all actions covered by the agreements varies from agreement to agreement. Some agreements include only a few persons, while others have large memberships.

From the standpoint of public policy, there do not appear to be real and compelling reasons for making *general* grants of immunity from the antitrust laws in time of war. A grant of immunity is a tremendous favor, and

since the granting of such a favor is discretionary, it is possible for all sorts of abuses to develop in the administration of the law.

The immunity provided in the Defense Production Act of 1950, restricting exemptions to acts specifically requested by the government and found to be in the public interest, appears to reduce the dangers of abuse. If the defense officials believe that a *particular* arrangement is necessary for the defense program, it is appropriate for the government to grant an immunity for *that arrangement*.

AGRICULTURAL MARKETING AGREEMENTS

The Agricultural Marketing Agreement Act of 1937, as amended, authorizes the Secretary of Agriculture "to enter into marketing agreements with processors, producers, associations of producers, and others *engaged in the handling* of any agricultural commodity or product thereof." Further, the Act provides that "the making of any such agreement shall not be held to be in violation of any of the antitrust laws of the United States, and any such agreement shall be deemed to be lawful . . ."[26]

The plan to use marketing agreements as a method for enhancing farm income was originally adopted in 1933 as a part of the "New Deal" for farmers. The view was that agricultural commodities should have a current purchasing power with respect to the things which farmers buy approximately equivalent to their purchasing power in the base period. The base period is August 1909 to July 1914, and this base period is the same for all commodities. In order to enhance farm prices, the federal government made provision for (1) "production control" in the case of numerous basic commodities and the payment of "benefit payments" to cooperators and (2) the establishment of marketing agreements, especially in lines of production not covered by the benefit payment program. Provisions for the use of marketing agreements were re-enacted in 1937, and this legislation has been continued to date.

A "marketing agreement" is a voluntary contract entered into by the Secretary of Agriculture and *handlers* of a particular agricultural commodity which is in the current of interstate commerce or which burdens, obstructs, or affects interstate commerce in the commodity. Such an agreement, in the first instance, affects only those who sign it. However, provision is made in the law for making the terms of the marketing agreement applicable to all handlers of the commodity, whether or not they sign the agreement. This is done by the issuance of a "marketing order" by the Secretary of Agriculture, declaring that the terms of the marketing agreement shall be effective upon all handlers of the crop in a given area. Generally speaking, a "handler" is defined to mean any person who handles the commodity under regulation, other than a producer in his capacity as a producer.

[26] 7 U.S.C. 601–608. Italics supplied.

Marketing agreements may cover any agricultural commodity. Marketing orders, however, may be issued only for certain designated products—mainly fresh fruits, vegetables, nuts, and milk. In some instances, marketing orders are issued without the existence of marketing agreements.

The Agricultural Marketing Agreement Act of 1937 provides for the issuance of an order classifying milk in accordance with the form or purpose for which it is used. It also provides for the establishment of a minimum price for each use classification which all handlers are required to pay to producers or cooperative associations of producers. As is the case with all orders issued under the Act of 1937, a public hearing must precede the issuance of a marketing order for milk, and no order can be issued unless it is approved by at least two-thirds of the producers, by number or volume, who deliver milk for sale in the marketing area to be covered by the regulation. As of July 1, 1960, there were federal milk marketing orders operating in 80 milk marketing areas. More than one-third of all milk sold at wholesale by farmers is now marketed under the terms of these orders.

Milk sold to consumers in bottles (glass or paper) is called Class I milk, and its minimum price to producers is the highest class-price. Milk from the same bulk containers used for making milk products is paid for at a lower price or prices.

The "parity" standard for milk and its products, the Agricultural Marketing Agreement Act provides, may be superseded whenever "the Secretary finds . . . that parity prices of such commodities are not reasonable in view of the price of feeds, the available supply of feeds and other economic conditions which affect market supply and demand for milk and its products." In setting prices above parity levels, the law provides, the Secretary "shall fix such prices as he finds will reflect such factors [cost of feeds and so forth], insure a sufficient quantity of pure and wholesome milk, and be in the public interest."

Federal milk orders establish minimum prices which are designed to influence marketings. The prices established are the minimum which handlers shall pay producers for milk. Resale prices for milk may not be fixed.

The purpose of a marketing agreement or a marketing order for fruits, vegetables, and tree nut crops is to control the *marketing* of a particular commodity so as to raise prices to farmers *to the parity* level. Under the "Declaration of Policy," the statute provides that the purpose of marketing agreements and marketing orders is "to establish and maintain such *orderly marketing conditions* for agricultural commodities in interstate commerce" as will return parity prices to farmers (italics supplied). Marketing agreements and orders for fruits, vegetables, and tree nuts may not contain provisions fixing specific prices. Control over prices is exercised indirectly by controlling the supplies which are shipped to consuming centers. A list of commodities covered by marketing agreements and orders is shown in Table 21.

The statute originally provided that no action was authorized which had

TABLE 21. Marketing Agreements and Orders in Effect for Fruits, Vegetables, and Nuts, 1960

Commodity	Area by State
Grapefruit	Arizona and California
Lemons	California and Arizona
Limes	Florida
Oranges, grapefruit, tangerines, and tangelos	Florida
Oranges, navel	Arizona and California
Oranges, Valencia	Arizona and California
Apricots	Washington
Avocados	Florida
Cherries	Washington
Dates	California
Dried Figs	California
Tokay grapes	California
Nectarines	California
Peaches	Colorado
Peaches	Georgia
Peaches	Utah
Bartlett pears, plums, and Elberta peaches	California
Winter pears	Oregon, Washington, and California
Dried prunes	California
Raisins	California
Potatoes	Colorado
Potatoes	Idaho and Oregon
Potatoes	Maine
Potatoes	Massachusetts, Rhode Island, Connecticut, New Hampshire, and Vermont
Potatoes	Oregon and California
Potatoes	Red River Valley
Potatoes	Eastern South Dakota
Potatoes	Southeastern States
Potatoes	Washington
Cucumbers	Florida
Onions	Idaho, Oregon
Peas and cauliflower	Colorado
Tomatoes	Florida
Tomatoes	Texas
Almonds	California
Filberts	Oregon and Washington
Walnuts	California, Oregon, and Washington

SOURCE: United States Department of Agriculture

for its purpose the maintenance of prices *above* the parity level. But there have been two amendments modifying this rule. An amendment of August 1, 1947, authorizes regulations for the purpose of maintaining minimum standards of quality and maturity, as well as grading and inspection requirements, even though prices may be affected and be above parity levels. Further, an amendment of August 28, 1954, authorizes the use of "rate of

flow" orders under certain circumstances even though prices may rise and be above parity. The amendment provides that "through the exercise of the powers conferred upon the Secretary of Agriculture . . . *to establish and maintain such orderly marketing conditions* for any agricultural commodity . . . *as will provide*, in the interests of producers and consumers, *an orderly flow of the supply thereof to market* throughout its normal marketing season to avoid unreasonable fluctuations in supplies and prices" (italics supplied).

Supply control under a marketing agreement program rests upon the "handlers" and is exercised by an "Administrative Committee" selected by the Secretary of Agriculture. Under all programs this committee has growers among its members. Indeed, under most fruit and vegetable orders there are more growers on the committees than wholesale dealers or distributors (serving as handlers).

The administrative committees act to regulate the quantities which may be shipped to particular central markets during a specified period. Products set aside to *decrease* market supplies are diverted to other uses—such as livestock feed—or are sold abroad at lower prices (see Figure 23). All regulations of the committees must be issued by the Department of Agriculture. The committees have no regulatory authority in and of themselves.

The administrative committees also investigate and make reports on violations to the Secretary of Agriculture. The Secretary, in turn, reports violations to the Department of Justice for prosecution. Three types of legal action may be taken against a violator. They consist of (1) civil action to secure an injunction preventing the person from further violation, (2) criminal action to impose a fine of not less than $50 and not more than $500 for each violation, and (3) civil action to assess damages equal to three times the value of the product shipped in violation of the order.

State Marketing Agreements Legislation

A number of states have adopted legislation to provide for the making of state-wide marketing agreements and orders in accordance with procedures similar to those specified in the federal law. Growers and processors in California, in particular, have turned to the use of such legislation to enhance their incomes. Products under marketing programs in California include early apples, asparagus, bush berries, cantaloupes, dried figs, grapefruit, honey, lettuce, lima beans, canned olives, peaches, pears, plums, potatoes, poultry, dried prunes, raisins, strawberries, and wine. Supplies in excess of "reasonable market requirements" for the season are set aside and diverted to other uses or outlets. The California legislation also makes provision for grading and inspection, advertising and promotion, the control of unfair practices, and the conduct of research.[27]

[27] *Parker* v. *Brown*, 317 U.S. 341 (1942), established the constitutionality of state regulation of products processed or prepared for market within the state even when such products are shipped in interstate commerce. This case also established that state marketing order programs are exempt from the federal antitrust laws.

FIGURE 23. Crates of Illegal Oranges. Under the marketing agreement for navel oranges, it is illegal for handlers to resell small-sized navel oranges, i.e., oranges 2¼ inches in diameter or smaller, in the United States or Canada. All such oranges can be sold only for conversion into by-products such as juice, or for export to countries other than Canada. This makes it possible to secure higher prices for the large-sized oranges, for it removes lower-priced substitutes. (*Daily News*, Los Angeles)

Producers and processors utilize statutes under state legislation in California in some instances because the authorizations permitted them under state marketing orders are not available under federal legislation. This category includes canned products and is applicable to advertising and trade promotion programs. In some instances, industries use State authorizations because of the necessity of rapid action. Federal procedures require compliance with the Administrative Procedures Act which makes changes of regulations impossible short of a three- or four-day period. Under state authorization in California, this can be reduced under extreme necessity to a matter of a few hours.

Agricultural Marketing Agreements and Our Traditional Policy of Competition

Federal and state legislation providing for the establishment of marketing agreements, it may be observed, gives handlers (including growers) of agricultural products the privilege to form legalized monopolies or cartels, if approval for concerted action is secured from the respective federal or state secretary of agriculture.

The use of marketing agreements as a means for enhancing farm prices was introduced during the period of the great depression. At that time the plight of farmers was a serious one, and Congress and various state legislatures were willing to approve a measure which made for artificial scarcity and higher prices. At the present time, however, with widespread needs—at home and abroad—for more and better food at lower prices, a policy of legalized monopoly in the pricing of essential foodstuffs, many economists believe, cannot be justified.

Persons stating the case *for* marketing agreements emphasize that prices for numerous farm products are not determined in competitive markets at central assembly points. Rather, in many situations, such prices are determined by the unilateral decisions of organized dealers. In such cases, farm producers have no voice in price determination and no remedy against the exercise of power to depress buying prices.

ASSOCIATIONS OF PRODUCERS OF AQUATIC PRODUCTS

The Fishery Cooperative Marketing Act of 1934 provides that

> persons engaged in the fishery industry, *as fishermen*, catching, collecting, or cultivating aquatic products, or *as planters* of aquatic products on public or private beds, may act together in associations, corporate or otherwise, with or without capital stock, in collectively catching, producing, preparing for market, processing, handling, and marketing in interstate and foreign commerce, such products of said persons so engaged. . . . If the Secretary of Commerce shall have reason to believe that any such association monopo-

lizes or restrains trade in interstate or foreign commerce to such an extent that the price of any aquatic product is unduly enhanced by reason thereof, he shall serve upon such association a complaint.[28]

Under the Reorganization Plan of 1939, the authority to supervise prices, serve complaints, and issue cease-and-desist orders was given to the Secretary of the Interior.

In the report of the House committee on the proposed Fishery Cooperative Marketing Act, it was stated that "the purpose of this bill is to provide for the fishery industry cooperative associations such as are provided for farmers by the Capper-Volstead Act. This bill applies to producers of aquatic products and not to farmers."[29]

Fishery Cooperative Associations

Fishermen have organized fishery cooperatives to improve their economic status. Some of these cooperatives have been concerned primarily with strengthening the fishermen's characteristically weak bargaining position in the market place. These cooperative organizations usually perform both a marketing and purchasing function for their members. Usually the members' catches are sold (1) by the manager through direct contact with buyers, (2) by special collective bargaining committees who meet with individual prospective buyers, or (3) in auction markets. Many fishery cooperatives now have adequate facilities for handling, processing, quick freezing, and storing of fish and shellfish, and are thus able to maintain a more uniform flow of these products into the market, effecting a degree of price stability. The number of fishery cooperatives is shown in Table 22.

TABLE 22. Number of Fishery Cooperatives in the United States, 1959[a]

Alaska	10	Oregon	3
Arkansas	2	New Jersey	3
California	15	Rhode Island	1
Florida	7	Washington	12
Louisiana	5	Wisconsin	1
Maine	10	Texas	1
Maryland	1	Cooperatives under supervision of the Bureau of Indian Affairs (mainly in Alaska)	6
Massachusetts	4		
Michigan	1		
Minnesota	1		
Missouri	1		
Ohio	2		

[a] A list of the names of the cooperatives may be secured from the Fish and Wildlife Service.
SOURCE: Fish and Wildlife Service, United States Department of the Interior.

[28] 15 U.S.C. 521. Italics supplied.
[29] *Authorizing Associations of Producers of Aquatic Products,* Committee on Merchant Marine, Radio, and Fisheries, 73rd Congress, second session, House Report 1504, May 7, 1934, p. 1.

The Provision of Market Information

For many years the Fish and Wildlife Service, through the Bureau of Commercial Fisheries, Branch of Market News, has provided those connected with the fishing industry with current market information. The Branch of Market News collects, compiles, analyzes, and dispenses information daily on landings, movements, cold-storage holdings, market conditions, and prices of fishery products and by-products in most of the important marketing centers throughout the United States. The Bureau encourages orderly marketing of the fishermen's catches. On request, current market information is regularly dispensed by telephone, telegraph, and teletype. Radio stations broadcast the information in some areas. Daily mimeographed reports, monthly and annual summaries, and periodic summaries are furnished on request to fishing industry firms and the public in general.

The Bureau's Branch of Economics conducts economic studies on production, distribution, and consumption of fishery products; the economic effect of technology and biological development in the fishing industry; price levels and marketing; labor conditions; and trade and tariff problems.

The Branch of Economics has a special Cooperatives Unit to obtain information on the activities of fishery cooperatives and to assure their compliance with the provisions of the Fishery Cooperative Marketing Act. This unit also renders educational, research, and other service work to fishermen through their cooperatives and often acts as adviser to groups of fishermen who wish to organize an association.

A Fishery Loan Fund was established by the Fish and Wildlife Act of 1956 to provide a source of loan capital for the fishing industry. The Act authorizes the Secretary of the Interior to make loans under specified conditions to (1) owners of fishing vessels and fishing gear and (2) persons doing research on basic problems of fisheries.

MANUFACTURING AND HANDLING OF HOG-CHOLERA SERUM AND HOG-CHOLERA VIRUS

Section 57, 49 Stat. 750, approved August 24, 1935, as an amendment to the Agricultural Adjustment Act, provides that "the Secretary of Agriculture shall have the power, after due notice and opportunity for hearing, to enter into marketing agreements with manufacturers and others engaged in the handling of anti-hog-cholera serum and hog-cholera virus . . . as is in the current of interstate or foreign commerce. . . . Such persons are hereafter in this Act referred to as 'handlers.' The making of any such agreement shall not be held to be in violation of any of the antitrust laws of the United States, and any such agreement shall be deemed to be lawful."[30]

Congress undertook to exercise a control over the manufacturing and

[30] 7 U.S.C. 852.

handling of hog-cholera serum and hog-cholera virus primarily to insure an adequate supply of uniform, high-quality, fresh products, sufficient to meet ordinary demands as well as those which might arise from an epidemic. Other factors leading to the adoption of the law were a need to stamp out unfair methods of competition and unfair trade practices in the marketing of serum and virus products.

About 50 percent of the annual production of hogs, it is estimated, is treated with hog-cholera serum and hog-cholera virus. In the use of the virus and serum, hogs are artificially infected with a mild case of cholera, and the serum is used to cure the disease and to immunize the hogs against future infection.

When the officials of the Department of Agriculture began to work with manufacturers of anti-hog-cholera products to secure uniform standards and adequate reserve supplies, the manufacturers, it is reported, insisted that they be permitted to set a price which would cover the higher costs involved. The *quid pro quo* for their cooperation, therefore, was the granting of their request that the antitrust laws be relaxed so that producers could assure themselves adequate prices.

At the present time, there are some thirty-one firms producing hog-cholera serum and hog-cholera virus; and in accordance with the marketing agreement which has been made, all firms sell at the same base price, with transportation allowed and prepaid to wholesalers or retailers anywhere in the United States. This price is established and managed by a "control agency" of twelve members, representing manufacturers and distributors.

RESALE PRICE-MAINTENANCE CONTRACTS

The Miller-Tydings Fair Trade Act (1937), amending the Sherman Act, provides

> That nothing herein contained shall render illegal, contracts or agreements prescribing minimum prices for the resale of a commodity which bears . . . the trade-mark, brand, or name of the producer or distributor of such commodity and which is in free and open competition with commodities of the same general class produced or distributed by others, when contracts or agreements of that description are lawful as applied to intrastate transactions . . .[31]

The purpose of the Miller-Tydings Act is to legalize the making of resale price-maintenance contracts in interstate commerce when such contracts are legal under state laws. By its terms, such contracts are removed from the prohibitions of the Sherman Act (1890) and are declared not to be an unfair method of competition under the Federal Trade Commission Act (1914). A resale price-maintenance contract, as we shall explain in a subsequent chap-

[31] 15 U.S.C. 1.

ter, is a contract made by a manufacturer of trademarked products which fixes the minimum wholesale and retail prices of such products as they move on to the final consumers (see Chapter 19).

AIR CARRIERS

The Civil Aeronautics Act (1938) provides that consolidations, mergers, interlocking directorships, and agreements between or among carriers with respect to rates and a pooling of earnings are prohibited unless they are approved by the Civil Aeronautics Board. Any person affected by such approved orders, the act provides, "shall be, and is, relieved from the operations of the 'antitrust laws' . . . in so far as may be necessary to enable such person to do anything authorized, approved, or required by such order."[32]

The air transportation industry in the United States developed with practically no economic regulation. Rate wars and cutthroat competition were frequent, and by 1938 a number of the carriers were facing serious financial trouble. During the hearings in 1938 on the bill to create the Civil Aeronautics Authority, an industry spokesman testified that chaotic conditions in the air transportation industry made it impossible to secure adequate investment funds. More than one-half of the private capital which had been invested in the air transportation system, it was stated, had already been lost.[33]

The difficult financial position of the industry, at the time the Civil Aeronautics Act was being written, appears to have been the principal reason which Congress had for permitting concerted action by the carriers on rates, provided that such agreements are approved by the Authority. It may be noted that the exemption granted to air carriers is essentially the same as that extended to the water carriers, as discussed in the section on the Shipping Act of 1916.

TELEGRAPH COMPANY MERGERS

Section 221, 48 Stat. 1080, approved March 8, 1943, provides that telegraph company mergers approved by the Federal Communications Commission are not within the purview of the antitrust laws which would otherwise make the transactions unlawful.[34]

This legislation was requested of Congress by the Federal Communications Commission in order to end the wasteful duplication of telegraph facilities. The Western Union Telegraph Company and the Postal Telegraph Company controlled the domestic public message service, and the opinion of the

[32] 49 U.S.C. 488, 489, 492, 494.

[33] *Civil Aeronautics Bill*, Committee on Interstate and Foreign Commerce, 75th Congress, third session, House Report 2254, April 28, 1938, pp. 1–2.

[34] 47 U.S.C. 221, 222(b), 222(c).

Federal Communications Commission was that substantial economies could be effected by a merger.

In reporting on the proposed legislation, the House Committee on Interstate and Foreign Commerce also emphasized the costly waste of maintaining duplicate facilities. According to the Committee,

> Already the government, through the Reconstruction Finance Corporation, has advanced around $9,000,000 to Postal to keep it going. Postal's current monthly loss is around $400,000. The Nation cannot afford to lose the telegraph service capacity represented by the facilities of that system. The existence of strong competitive modes of communication outside the telegraph industry means, moreover, that merger of the domestic telegraph carriers will not result in a monopoly in the domestic communications field. If such a merger occurs, there will still remain severe and effective competition between the merged telegraph company and the telephone and the air-mail.[35]

On May 13, 1943, the Western Union Company announced the completion of an agreement by which it would purchase the Postal system outright, and the proposed agreement was subsequently approved by the Federal Communications Commission. From an economic point of view, a merger of the only two telegraph companies in the nation does, in fact, create a monopoly in the telegraph business. The competition of airmail and telephone services can only be classed as *substitute* competition.

INSURANCE COMPANIES

The McCarran Act (1945) partially exempts insurance companies from the federal antitrust laws. After June 30, 1948, it is provided that the federal antitrust laws shall be made applicable to the business of insurance "to the extent that such business is not regulated by the state law."[36]

At the time of their establishment in the United States, insurance companies, like banks, considered themselves to be a local business, subject to control by the states. An early group of Supreme Court decisions supported this view and held that insurance was not "commerce" and therefore not subject to federal regulation.[37] As a result, most of the states adopted various systems of regulation. Many abuses, however, developed under state regulation. In particular, important groups of insurance companies adopted the practice of meeting together to make their rates by agreement.

In 1944 the Supreme Court rendered its decision in the South-Eastern

[35] *Consolidations and Mergers of Domestic Telegraph Carriers*, Committee on Interstate and Foreign Commerce, 78th Congress, first session, House Report 69, February 1, 1943, p. 3.

[36] 15 U.S.C. 1011–1013.

[37] *Paul* v. *Virginia*, 8 Wall. 168 (1868): The other cases are reviewed by Justice Black in *U.S.* v. *South-Eastern Underwriters Assn.*, 322 U.S. 533 (1944).

Underwriters Association case, which the Department of Justice had brought to test the validity of monopolistic action in rate making in the fire insurance field.[38] In brief, the Court held that the "business of insurance" is commerce and that the federal antitrust laws are applicable to insurance companies which conduct their activities across state lines. This decision meant (1) that every insurance company engaging in interstate commerce—and most companies are—shall henceforth act independently in making its rates and (2) that there shall be no private agreements or coercion on rates among insurance companies.

The state antitrust laws have never been effectively enforced, and many insurance company executives believed that they were effectively insulated from price competition. The South-Eastern decision, placing insurance companies under the Sherman Act, accordingly proved to be very unsettling, for it threatened to upset collective action in rate-making. Thereupon, insurance companies turned their attention to Congress. At first an attempt was made to secure general legislative exemption from the Sherman Act for the insurance business. This approach failed, however, and a compromise measure was finally worked out in the McCarran Act of March 9, 1945.

The McCarran Act affirms the principle of state regulation, which the insurance companies desire to preserve, and provides that no act of Congress shall be construed to invalidate or supersede laws enacted by the states to regulate insurance companies. However, after June 30, 1948, the act declares, the Sherman, Clayton, and Federal Trade Commission Acts "shall be applicable to the business of insurance to the extent that such business is not regulated by State law." The meaning of this legislation is that in so far as the states provide "regulation" over rates, the Department of Justice is kept out. In effect, therefore, the McCarran Act grants the insurance companies a *partial exemption* from the federal antitrust laws.[39]

In a special statement on the McCarran Act, President Roosevelt declared on March 10, 1945: "Congress did not intend to permit *private* rate-fixing, which the Antitrust Act forbids, but was willing to permit actual regulation of rates by affirmative action of the states." The burden of direct control has thus been placed squarely on the shoulders of the states.

Are the fifty individual states now providing a satisfactory level of regulation and direct control over rates in the insurance industry? This is a controversial question. In most states, rates for fire, casualty, and inland marine insurance are *initially* fixed by private "rating bureaus" whose services (formulation of rates) are subscribed to by the companies. Life insurance rates are usually free of control, and public supervision is primarily concerned with the financial soundness of life insurance companies. Rates for ocean marine insurance are not controlled.

[38] *U.S. v. South-Eastern Underwriters Assn.*, 322 U.S. 533 (1944).

[39] The McCarran Act provides further that the Sherman Act shall continue to be applicable "to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation."

The case for state regulation of insurance finds support in the fact that the state commissions are typically maintaining high standards *for the investments* made by insurance companies and *for the adequacy of their reserves* to meet policy commitments. The state commissions, moreover, perform an essential service in (1) regulating the types and coverage of policies sold within their respective jurisdictions and (2) assisting policyholders to secure a prompt and fair settlement of their claims. State commissions are aware of local problems, and their activities are responsive to the needs of local people. The main issue in state regulation is whether the states, acting individually, can and do provide adequate control over rates to keep them down to competitive levels.

The McCarran Act contemplates that state control will protect the public from excessive rates, in lieu of competition under the federal antitrust laws. What form does state control take? State insurance legislation typically provides that "premium rates for insurance shall not be excessive, inadequate, or unfairly discriminatory." What is an excessive rate? No standards are given, and each of the state commissions proceeds to approve or disapprove rates in accordance with its own views and opinions. The effectiveness of rate control is further limited by the fact that most states do not have adequate facilities for supervising rates. In many instances, the state insurance commission consists of one commissioner and only a few staff members. Inadequate personnel and funds appear to be the rule. The office of insurance commissioner, moreover, is a political position, either appointive or elective, and frequent changes in personnel make it difficult to pursue a firm and consistent policy.

At the present time, it appears that buyers of insurance secure a measure of protection against excessive rates from (1) the considerable number of companies operating in each field, (2) the pressure of various companies to offer moderate rates in order to secure business, and (3) the operation of mutual companies which refund a portion of the premium income to policyholders. If competition on rates were promoted by the government, instead of being curtailed, it is probable that it would provide a much greater protection against excessive rates. At the same time, state control could be utilized to supervise sales and the adequacy of rates at local levels.

Special Exemption Enjoyed by Marine Insurance Companies

A special exemption from the antitrust laws was granted to associations of marine insurance companies in the Merchant Marine Act of 1920. According to this statute, "Nothing contained in the 'antitrust laws' . . . shall be construed as declaring illegal an association entered into by marine insurance companies . . . to transact a marine insurance business and reinsurance business in the United States."[40]

The exemption granted to associations of marine insurance companies ap

[40] Act of June 5, 1920, c. 250, 41 Stat. 988, 46 U.S.C. 885.

pears to have been made on the ground that it would serve to encourage their development. Thus, the Senate Committee on Commerce in its report on the legislation declared: "If we can develop marine insurance as it should be developed in this country, we can do nothing better for an American (merchant) marine. Only about 10 percent of our hull insurance and only about 25 or 30 percent of all kinds of our marine insurance are done today by American companies."[41]

RAILROADS AND OTHER SURFACE CARRIERS SUBJECT TO CONTROL BY THE INTERSTATE COMMERCE COMMISSION

The Reed-Bulwinkle Act (1948), amending the Interstate Commerce Act, provides that "Parties to any agreement approved by the Commission . . . are . . . hereby relieved from the operation of the antitrust laws with respect to the making of such agreement, and with respect to the carrying out of such agreement in conformity with its provisions and in conformity with the terms and conditions prescribed by the Commission."[42]

The essence of the Reed-Bulwinkle Act is that agreements on rates made by railroads, truck lines, and inland waterway carriers subject to the jurisdiction of the Interstate Commerce Commission, if approved by and filed with the Commission, shall be relieved from the operation of the antitrust laws. The Commission, moreover, is instructed to approve rate agreements if it finds that they further the national transportation policy. In addition to the exemption provided in the Reed-Bulwinkle Act, the Transportation Act of 1940 provides that agreements made with respect to a division of traffic and joint rates, as well as mergers, leases, and acquisitions, if approved by the Interstate Commerce Commission, shall be exempted from the operation of the antitrust laws.[43] The act of 1940 amended and codified a series of earlier acts providing for such types of joint action by the railroads. The provisions in the Reed-Bulwinkle Act, legalizing monopolistic activity on rate making, it may be noted, are essentially the same as those contained in the Shipping Act of 1916 and the Civil Aeronautics Act of 1938.

Background for the Legalization of Cartel Activity in the Surface Carrier Field.

The Supreme Court in the Trans-Missouri Freight Association (1897) and Joint Traffic Association (1898) cases held that the Sherman Act applies to agreements on rates in the railroad field, as well as in industry, and declared

[41] *Promotion and Maintenance of the American Merchant Marine*, Committee on Commerce, 66th Congress, second session, Senate Report 573, May 4, 1920, p. 9.

[42] Public Law 662, 80th Congress, second session.

[43] 49 U.S.C. 5.

that combinations of railroads for fixing rates are illegal.[44] Subsequently, however, the Sherman Act was not again applied to collective action on rates until 1942, when the Department of Justice initiated a grand jury investigation in Chicago against the price-fixing activities of rate bureaus and carrier-shipper rate conferences. The point of view taken by the Department of Justice was that joint action by the railroads in the form of rate bureaus, conferences, or otherwise, to agree upon and fix the rates that are filed with the Interstate Commerce Commission, is illegal per se. A "rate bureau," it may be noted, is an association of carriers operating in a certain area, formed for the purpose of fixing the rates to be submitted to the Interstate Commerce Commission. A "carrier-shipper conference," on the other hand, is a meeting of carriers and shippers in a given region or area to consider proposed changes in rates. Rate conferences are arranged by the organized railroads, and their purpose is to give shippers an opportunity to express their views on rate proposals and also to provide the carriers with an opportunity to estimate more precisely the rates which the traffic will bear.

The position of the Department of Justice was subsequently strengthened by the decision of the Supreme Court in 1945 in *Georgia* v. *Pennsylvania R.R. Company*.[45] The state of Georgia had charged a group of carriers with collusive action to maintain rates which were discriminatory to Georgia, and in a preliminary decision the Court held by a five-to-four vote that the state could bring action against the alleged conspiracy. In the view of the Court, the Sherman Act was still fully applicable to the railroads.[46]

The determined effort of the Antitrust Division to prosecute railroad rate agreements, as well as the decision in the Georgia case, stimulated efforts by the Association of American Railroads to seek exemption from the antitrust laws by legislative action. In the view of the railroads, rate bureaus and rate conferences had been continuously and openly used for over fifty years. They had been used, moreover, with the full knowledge of the Interstate Commerce Commission and the Department of Justice. Collective action on rates, it was stated, provides a practical procedure whereby any shipper or any carrier may propose rate changes, secure advance notice of any proposed changes, and present evidence against rate changes which would affect his business adversely. The legislative battle over the Reed-Bulwinkle bills was bitter and prolonged, but finally in June, 1948, the organized railroads were able to secure the passage of the desired legislation over a presidential veto.

PRODUCTION CONTROL IN THE OIL INDUSTRY

The control of production in the oil industry is an additional area which is outside the purview of the Sherman Act. Production control in petroleum finds its legality not in a specific exemption, but rather in the fact that

[44] 166 U.S. 290 (1897) and 171 U.S. 505 (1898).
[45] 324 U.S. 439 (1945).
[46] 324 U.S. 439, 456–457 (1945).

monopoly action exercised by, or through, a state government does not violate the federal antitrust laws.

The Supreme Court has held that when restrictions on production are directed by state action, they are not covered by the Sherman Act. Thus, in *Parker* v. *Brown,* the Supreme Court held that a plan for restricting the marketing of raisins, directed and required by a state government, for the expressed purpose of reducing competition and maintaining prices, is not in violation of federal antitrust laws, as the regulation is accomplished by command of the state, not by agreement of private persons.[47] Said Chief Justice Stone: "We find nothing in the language of the Sherman Act . . . which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature . . . the Sherman Act makes no mention of the state, as such, and gives no hint that it was intended to restrain state action or official action directed by a state." Since the restriction of oil production is accomplished by statutory power, not by voluntary agreements of producers, compliance with orders controlling production does not violate antitrust laws.[48]

Nearly all the principal oil-producing states have established agencies with power to limit the production of oil and gas to prevent waste. In exercising this control, a commission usually determines (1) the daily allowable production for each field and (2) the daily quota for each well or unit area.

In establishing state-wide output quotas, a state agency may consider the monthly forecasts or estimates of "market demand" which are prepared by the Bureau of Mines (United States Department of the Interior). This agency has been preparing such estimates since 1935, except for the World War II period, when the forecasts were made by the Petroleum Administration for War, an agency of the Department of Interior. These are forecasts of the amount of production in various states or areas that will be needed to supply current consumptive uses, considering probable imports, withdrawals from storage, and other factors. There is no legal compulsion for a state agency to follow the forecasts or estimates of the Bureau of Mines, and frequently a commission arrives at an entirely different decision.

The estimates supplied by the Bureau of Mines are only a part of the evidence considered by a state agency in regulating production. The "nominations" of the purchasers of crude oil, representing their statements of the amounts they need for current use and are willing to buy over the next period—usually one month—are also considered by some of the agencies as a factor in determining market demand. An increase or decrease in aboveground storage is another important factor considered in the decision reached.

In order to strengthen the control exercised by the states, the federal government enacted the Connally "Hot Oil" act of 1935. Hot oil is that pro-

[47] 317 U.S. 341, 350–351 (1943).

[48] See also Robert E. Hardwicke, "Antitrust Laws and the Conservation of Oil and Gas," *Tulane Law Review*, December, 1948, pp. 183–208, and *Antitrust Laws et al.*, v. *Unit Operation of Oil or Gas Pools* (New York, 1948), pp. 169–173.

duced, or withdrawn from storage, in excess of valid orders of the state. The act of 1935 prohibits the use of interstate commerce facilities in moving illegally produced oil or oil withdrawn from storage in excess of state regulations. The act also provides for the forfeiture to the federal government of the oil so shipped. In actual practice, the custom has been to proceed against violators by means of criminal proceedings. Administration of the Connally Act is under the Department of the Interior, but enforcement is handled by the Department of Justice, through local federal district attorneys or special assistants.

Since a considerable part of the petroleum output is controlled to conform to "reasonable market demand," it is important to consider the meaning of this term. In an economic sense, "market demand" means the amount, or number of units, which will be taken at a given price. Critics of the state programs point out that to the extent that market demand is used as a guide in curbing output, the Bureau of Mines and the state agencies must necessarily take into account the amounts which it is believed can be sold *at given prices*. They further point out that there is evidence that prices for petroleum products are "administered" or "managed" prices, established by "price leaders." In part, therefore, it is said, the control plan exercised in petroleum is one in which the state and federal governments limit oil production to the outputs which the large refiners can sell at managed prices.[49]

Advocates of market-demand limitation, on the other hand, maintain that limitation of production to reasonable current needs is an effective way to prevent the physical waste that always results when production materially exceeds the current consumptive needs. Such limitation is also a reasonable and effective way to protect the rights of owners of oil and gas lands, giving each the opportunity to produce and market his share of the common supply. The basic and principal purpose of state regulation, they contend, is conservation. The aim is not to create a shortage or affect price, but to supply the current consumptive needs if it can be done without causing waste.[50]

THE NEED TO RECONSIDER EXEMPTIONS FROM THE ANTITRUST LAWS

It is recognized that in certain segments of the economy (notably in the case of railroads, airlines, telegraph lines, shipping lines, labor unions, and

[49] George W. Stocking, "Stabilization of the Oil Industry Its Economic and Legal Aspects," *American Economic Review, Papers and Proceedings*, March, 1933, pp. 55–70, and E. V. Rostow, *A National Policy for the Oil Industry* (New Haven 1948), pp 70–87.

[50] Robert E. Hardwicke, "Antitrust Laws and the Conservation of Oil and Gas," *Tulane Law Review*, December, 1948, pp. 198 199, and "Market Demand as a Factor in the Conservation of Oil," *Institute on Oil and Gas Law* (1st Annual, 1949), p. 140, and G. A. O'Connor, Jr., "Role of Market Demand," *Compact Bulletin*, June, 1958, p. 40.

cooperative associations) it is not possible or practical to have two-sided price competition. It is possible, however, in such cases, to preserve and maintain *competitive pressures* to moderate the extreme demands made by certain sellers. A particular railroad company, for example, having considerable degrees of local monopoly power along its line, is usually competitive with other railroads at certain points. It is also frequently competitive with other forms of transportation—such as water, motor, and air. It is possible for government to utilize these competitive pressures to moderate the demands of a given railroad company for higher rates by requiring each business unit to make its rates independently. The resulting competition is not perfect or pure, or even the type normally called for by the antitrust laws. It is, however, a form of competitive pressure—or substitute competition—which the antitrust laws contemplate and which Congress can effectively maintain.

In the case of labor unions, the principle of collective bargaining is now firmly established and accepted. The acceptance of collective bargaining, however, does not mean that there must be a complete organization of all *employers* in a national industry or of all *employees* in that industry for bargaining purposes. That would mean complete, two-sided monopoly, without competitive pressures to moderate the demands of either party.

A long step has been taken in the direction of a universal system of legalized private monopoly. The continued acceptance of such a system, it is generally believed, can only lead to a greater amount of government intervention in business, for consumers, generally, will increasingly demand the imposition of direct controls over the privately managed prices.

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Patents and the Antitrust Laws

A basic economic function of government, we have seen, is to create and establish institutions which will increase the real income—the level of living—of consumers generally. As a means to this end, governments in Europe early undertook to encourage technology and the useful arts by granting inventors and authors property rights in their inventions or writings for limited periods of time. In the present chapter, we shall consider the activity of the United States in promoting the progress of science by granting property rights in the form of patents as a reward for invention. Consideration will be given to the nature of patents, to the monopolistic abuses which have arisen in their use, and to various proposals which have been made for improving the work of government in stimulating industrial research and invention.

Government, it may be noted, has the task not only of advancing technology, but also of making its gains available to the people—to the nation as a whole. It is here that public policy with respect to prices and incomes is important. One of the purposes of competition is to provide a means by which improvements in technology will be passed on to consumers in the form of more and better goods at lower prices. Government, in the economic sphere, therefore, has the twofold duty of (1) stimulating invention and the useful arts and (2) adopting measures which will insure that the fruits of material progress will be passed on to consumers in the form of a constantly rising level of living (see also Figure 24).

THE USE OF PATENTS TO INDUCE DISCLOSURE OF NEW IDEAS

With the rise of strong national states in Europe at the close of the Middle Ages, sovereigns began to exercise their power in ways which they believed would increase the general good. In England in 1331, for example, John Kempe, a weaver from Flanders, was given a grant of the king's protection in return for his promise to teach the weaving art to workers in England.

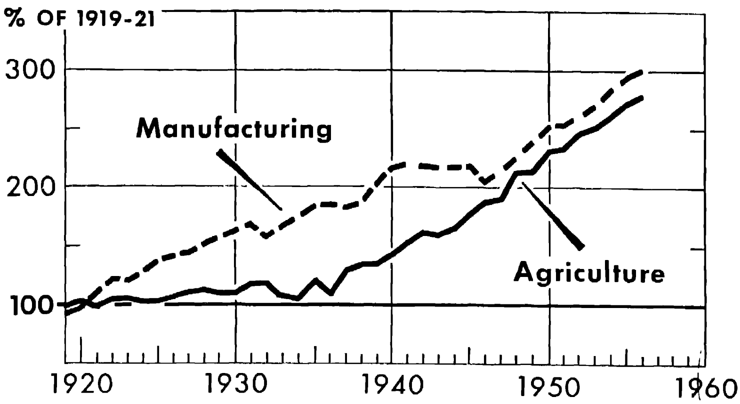

FIGURE 24. The Rising Trend of Output Per Man-Hour in Industry and Agriculture. Advances in technology have been the chief basis for the rise in productivity. (Source: United States Department of Agriculture)

Gradually the kings began the practice of making patent grants as a reward to enterprisers for introducing new arts and processes. Although the prerogative of the kings was frequently abused by the practice of granting patent rights for contributions to the royal treasury, the growing power of Parliament in England largely curbed such abuses by the enactment of the Statute of Monopolies in 1624. This famous statute condemned private monopoly in the regularly established trades but recognized limited grants of exclusive privilege for "new manufactures."

In holding out a property right to inventors, the sovereigns sought to induce inventors to bring "trade secrets" out into the open so that they could be made a part of the common knowledge of society. As an inducement and reward for doing so, *litterae patentes* were granted to inventors giving them the right to exclude others from making, using, or vending their invention for a limited number of years, after which the invention was to become free to all to use without restriction. The word "patent," it may be noted, comes from the Latin *patens*, present participle of *patere*, "to be open," and the "open letters" granted by a sovereign to inventors were addressed to all citizens in the realm.

Legal authorities have long considered the granting of patent rights to inventors to be a fair method of compensating them for the expense and arduous work which are usually involved in research and scientific invention. Inventions, it is often said, are a product of genius, but it has also been observed that genius is about 2 percent inspiration and 98 percent perspiration. The right of limited monopoly offered to inventors is thus a sort of *quid pro quo* for the time, effort, and money which ordinarily must be spent in developing a new formula, machine, or process.

In formulating the relations of government to business in the United States,

the framers of the Constitution provided in 1787 that "the Congress shall have power . . . to promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries" (Art. 1, Sec. 8). The constitutional provision on the making of grants of "exclusive right" to authors and inventors was implemented by statute law in 1790, 1793, 1836, 1870, and 1952. The Patent Act of 1952 was adopted to codify existing patent statutes and also to make actual changes in the statutes, particularly with reference to the conditions for patentability.

THE NATURE OF PATENTS

A patent in American law may be defined as a grant from the government to an inventor of "the right to exclude others from making, using, or selling" the invention claimed in the patent grant. The right to exclude others exists for a period of seventeen years and extends throughout the United States and its territories. When the government actually issues a patent to an inventor, it sends him a certificate, with a blue ribbon and red seal, in which it is stated that the government has granted the inventor the right to exclude others from making, using or selling the invention. In principle, a patent is the grant as recorded on the certificate; but in the vernacular, the word "patent" means the printed copy of the specifications and claims. A printed copy of any invention on which a United States patent has been issued may be secured from the Patent Office for 25¢.

A patent grant gives an inventor the right to exclude others for a limited period of time from making, using, or selling a product—such as a flashlight battery—*according to the formula, machine, or method developed by the inventor*. What the patent does for an inventor is merely to give him a right —in effect, a sword—by which he can exclude others from practicing *his* invention. The phrase "exclusive right," when used in the field of patents, means the right to employ legal processes to exclude others. The phrase "patent monopoly," in turn, refers to the property right vested in an inventor and created by statute, to exclude others from the practice of the invention set forth in the claims of the patent.

Patents on an article or process are called "utility" patents. The patent laws provide also for "design" patents and for "plant" patents. A design patent is granted to any person who has invented any new, original, and ornamental design for some article of manufacture—such as a dress, suitcase, bottle, or radio cabinet. Design patents are issued for a term of three and a half, seven, or fourteen years, as the applicant may elect. The fee for each period is different.

A plant patent is granted to anyone who has invented or discovered and asexually reproduced any new variety of a plant, flower, rose, or fruit. The term "asexually reproduced" means that the new variety is reproduced by

means of cuttings, budding, grafting, or layering, and not by seeds. The Plant Patent Act is an amendment to the general patent act and was passed by Congress in 1930.

PATENT RIGHTS SUBJECT TO THE ANTITRUST LAWS

It is sometimes said that the patent system of exclusive rights is incompatible with our antitrust law policy of preventing monopoly and maintaining competition. Both arrangements, however, have as their purpose the encouragement of production and economic abundance. The basic purpose of patents is to encourage inventors by giving them exclusive rights over their inventions. Although others cannot use a patent without permission of the owner, they are free to invent something of their own, toward the same end. This stimulates rivalry to make improvements. The public advantage in getting new products, or more economical processes of production, it is believed, outweighs the evils of exclusive control which, presumably, will continue for only a limited period of time.

The "main object" of a patent grant, as Justice Storey declared in 1830, is "to promote the progress of science and useful arts," and the reward held out to inventors is merely a means to that end.[1] Likewise, in the Mercoid Corporation case (1944), decided more than one hundred years later, the Court declared that "it is the public interest which is dominant in the patent system," and every claim of a patent owner is to be tested by this principle.[2]

The constitutional provision giving Congress the right to grant authors and inventors exclusive rights to their writings and discoveries does not authorize Congress to grant a monopoly for a certain class of goods. The rights conferred in a patent or copyright, moreover, are subject to restraint by the Sherman Antitrust Act which condemns conspiracies and monopolization of the whole supply of a given class of goods.

THE ADMINISTRATION OF THE PATENT SYSTEM

Any person, except an employee of the Patent Office, may apply for a patent by submitting an application to the Patent Office in Washington, D.C. In filing an application, inventors usually find it advantageous to employ the services of counsel skilled in patent matters to make sure that the patent specifications and claims properly describe and claim the invention. Patent counsel can also aid an applicant in many of the problems which arise during the development and exploitation of his invention. About 60 percent of the patent applications filed with the Patent Office result in patents.

[1] *Pennock* v. *Dialogue*, 2 Peters 1, 19 (1830).

[2] *Mercoid Corp.* v. *Mid-Continent Investment Co.*, 320 U.S. 661, 665 (1944).

When a patent application is received by the Patent Office, it is referred to the appropriate division for study and investigation by the examiners of that division. There are sixty-seven divisions in the Patent Office, and each one specializes in the innovations which arise in a given category of products—such as optics and photographic apparatus. The period from the filing of the application to its issue as a patent or its abandonment is known as the "prosecution before the Patent Office"—sometimes called the period of patent pending. This period may be as long as three years or more, and during the interval no patent protection is provided. The term "patent pending" has no legal significance. It serves only as a warning that a patent may be issued.

During the "prosecution," the patent examiners make a search of the prior art (earlier patents and other publications) to ascertain the newness of the disclosed and claimed invention. If the facts warrant, certain or all of the claims of the application are rejected as unpatentable. The claims of the application may, thereupon, be amended or modified in accordance with the original disclosure of the application. New subject matter relating to the invention, however, may not be added to the disclosure in the application as originally filed.

If a patent application satisfies the appropriate division, the application is allowed and a patent is granted upon payment of the final fee. Over 1000 patents are issued each week.

Patent applications which are rejected by an examiner may be carried to the Board of Appeals in the Patent Office. It is reported that the Board of Appeals reverses the decisions of examiners in part or in whole in nearly one-half of the appeal cases. A patent is only *prima facie* valid, and its validity may always be questioned in an appropriate court action.

Under the Constitution and patent laws of the United States, patents are granted only to individual "inventors." Individual patent owners, however, are permitted to license or assign their patents to other persons, to corporations, or to the government. The usual practice of corporations and governmental departments is to require employees to assign to the employer all inventions developed in the course of their employment. Some companies pay extra compensation for new inventions; but ordinarily extra payment is not provided on the ground that technical employees and those engaged in research are only doing that which they are hired to do.

THE RIGHT TO EXCLUDE OTHERS DEPENDS UPON THE SCOPE OF THE PATENT AND PROOF OF INVENTION

A patent right, we have said, is the right to exclude others from making, using, and selling a product, formula, process, or method conceived by the inventor. In applying for a patent it is necessary for an inventor to (1)

describe the invention and (2) state precisely and distinctly the invention which is claimed—such as a process for making tungsten filaments for use in electric lamps, the use of gas in electric lamp bulbs to increase the intensity of the light, a way to make a synthetic vitamin, a method for creating high-vacuum tubes, or a process for bronzing iron by the application of heat and oil. The "claim" or "claims" of the invention mark out the four corners of the process, mechanism, method, or formula which an inventor claims as his new invention and from which he seeks to exclude others. A patent right, when granted, excludes others only from that which is delineated by the claims of the patent. Everything else is free from exclusion. It follows that a person infringes the patent of another only when he comes within the scope of another's patent. At all times, a person is free to "invent around" a patented invention, if he is capable of doing so.

CHARACTERISTICS OF PATENTABLE INVENTIONS

The Patent Act of 1952 provides that patents will be granted to "whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof." A formula, method, or device, in order to be patentable, must be (1) "new" and (2) "useful." The term "new" means that the claimed innovation was not known to the public prior to the date of the patent application. In addition, (3) a particular contribution must have "some mysterious ingredient connoted in the term 'invented.' " In general, it may be said that the courts have sought to make patentable "invention" turn either upon (1) the existence of a substantial degree of individual ingenuity in developing the new process or (2) the presence of a substantial degree of technical advance in the object invented or in the process of producing something. The first rule, which is called the *subjective* test, emphasizes the degree of inventive genius shown by the inventor. Its existence in a given situation is indicated, apparently, by whether or not the new process would surprise a person skilled in the regular method of manufacture. The invention must reveal "inventive genius" or "a flash of creative genius" and be really startling. The second rule is called the *objective* test. This test makes patentability turn on the objective element of technical advance in the process, method, or device.

The "flash of genius" doctrine or test has been actively opposed by spokesmen for large corporations, for their desire is to secure patents on inventions which are the product of teams of men working in a routine way. In the laboratories of large corporations, research projects are conducted over periods of several years by paid employees, and the results are achieved by the step-by-step progress of all the workers rather than by the genius of any one individual.

CONGRESS REJECTS THE "FLASH OF GENIUS" TEST

In an effort to resolve controversy over the test which the courts should use in passing upon the validity of patents, Congress in the Patent Act of 1952 adopted the *objective* test for patentability. The new statute provides that patentability shall turn on "the differences between the subject matter sought to be patented and prior art" (Section 103). *If the differences are substantial, a patent will be issued.* If, however, the differences would have been obvious at the time of the claimed innovation to a person having ordinary skill in the art, a patent will not be granted.

Section 103 explicitly states that "patentability shall not be negatived by the manner in which the invention was made." This means that it is immaterial whether the invention was developed by a "flash of genius" or by long toil and experimentation in well-financed laboratories. The proviso in Section 103, the records show, was specifically directed to decisions based upon the Cuno Engineering case which set forth the "flash of genius" approach, and also to those based upon the Potts case which took a dim view of inventions resulting from planned research in the laboratories of large corporations. It is believed that this provision of the Patent Act of 1952 is so specific in indicating the intention of Congress to set aside the Cuno and Potts cases that the courts will be unable to avoid recognizing the new rule.[3]

The Patent Act of 1952, it may be noted, does not provide detailed standards or rules for determining "invention." It is possible, therefore, for a court which is unsympathetic to patents to disclaim the Cuno and Potts cases and at the same time hold a particular patent invalid on the ground that the changes do not rise to the status of invention. In the United Mattress Machinery case (1953), a Court of Appeals stated that Congress had made no detailed attempt in the Patent Act of 1952 to define the term "invention" and that it was for the courts, themselves, aided only by case law, to determine what constitutes invention and what does not.[4]

The problem of providing a uniform standard for testing inventions still remains. Whether or not an innovation constitutes "invention" depends in large measure upon the personal, political, and economic attitudes of a particular court. Patent attorneys generally regard certain Courts of Appeal as being more favorable to patents than others. The Supreme Court itself has varied in the support which it has given to patentees. Following 1937 and the emergence of the "New Deal" economic and political climate, there developed a trend in decisions which progressively weakened the paten-

[3] In *Gagnier Fibre Products Co.* v. *Fourslides, Inc.*, 112 F. Supp. 926 (1953), District Judge Picard acknowledged that Sec. 103 of the Patent Act of 1952 rejects the "flash of genius" test used in the Cuno case.

[4] *United Mattress Machinery Co.* v. *Handy Button Machine Co.*, 108 F. Supp. 899 (1953).

tee's position. It is possible that a climate more favorable to patent owners will again develop.

INFRINGEMENT SUITS AND THE INVALIDATION OF PATENTS

In manufacturing activity, business firms are almost constantly faced with the problem of making something whose production is covered in some way by patents held by others, or of having someone else turn out a product on which they have a patented method of production. The number of unexpired patents existing at any given time in the United States, in recent years, has been in excess of 600,000. Since each firm having a patent proposes to keep anyone else from making the product according to its invention without its permission, a large number of infringement suits necessarily arise in business. An infringement suit is one brought by a patent owner against a person allegedly encroaching upon his patent right.

The striking thing about infringement suits is the fact that a substantial part of the patents litigated have been held by the courts to be unenforceable in the particular cases, either (1) because the activity of the accused is held to be outside the scope of the plaintiff's patent or (2) because the plaintiff's patent really represents no "invention." One well-known patent attorney declares that his experience with a large number of patents over a period of nearly two decades has led him to conclude that "out of one hundreds patents, ninety can be discarded with little more than a cursory examination. Of the remaining, nine will not withstand a strict examination. This leaves, at the most, one patent that has more than a fighting chance of being declared enforceable."[5] Illustrations of patents which have been held to be valid in infringement suits are shown in Figures 25 and 26.

The fact that a great many patents are held to be invalid and unenforceable is to be explained largely by (1) the inadequate search made by the Patent Office of the records of prior use to determine whether or not the public had prior knowledge of the invention claimed and (2) the lower standards for invention followed by the Patent Office in comparison with those adopted by the courts. Even among the courts, there is variation in the standards used for determining invention, depending upon the personal, political, social, and economic attitudes of the various judges.

The Patent Act of 1952, we have seen, established tests for patentability more favorable to patentees than existed under the old legislation. No part of the new law, however, made provision for harmonizing the standard for invention used by the Patent Office and the standard used by the courts. Experienced patent attorneys believe that the Patent Office will continue to be very liberal in granting patents and that the courts will continue to follow

[5] Daniel G. Cullen, "The General Lawyer and Patent Problems," *Lawyers Guild Review*, September, 1946, pp. 585–589.

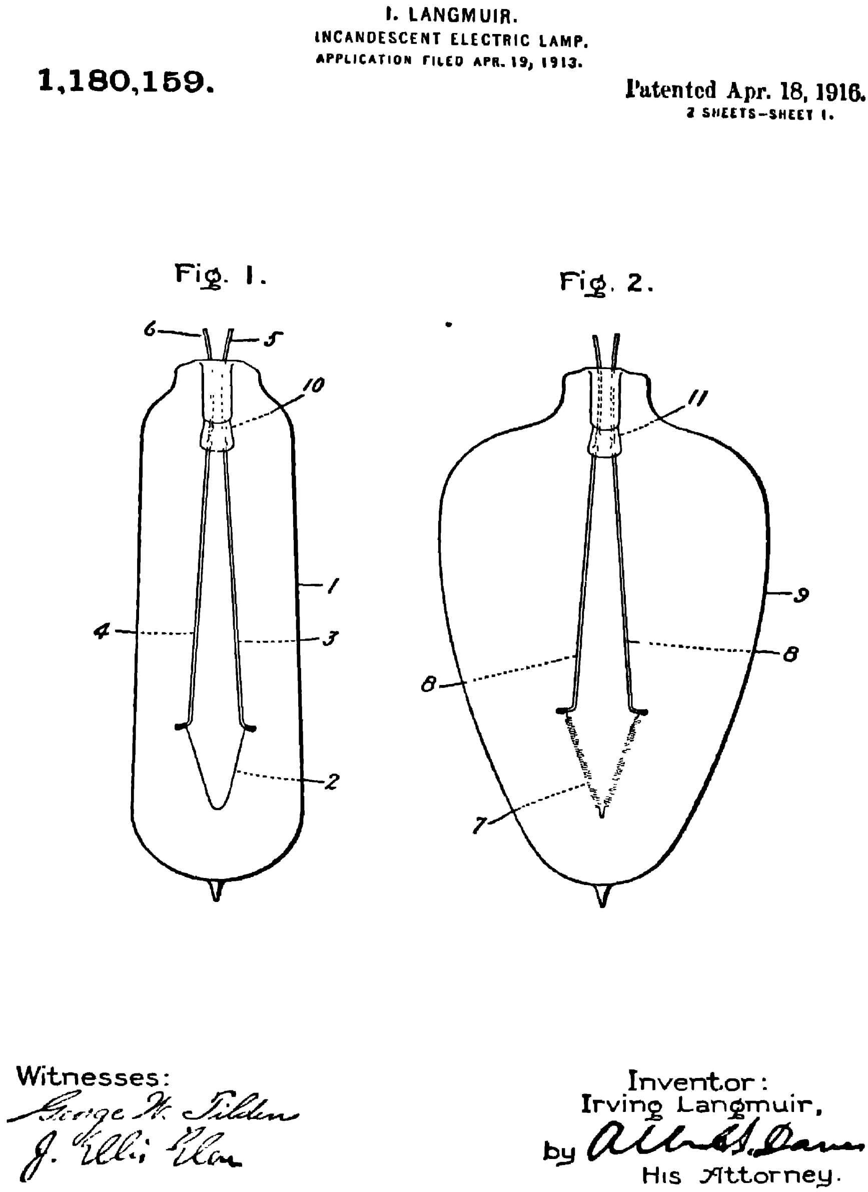

FIGURE 25. A drawing of the Langmuir Patent Issued in 1916 for an Incandescent lamp (1) Filled with Compressed Gas and (2) Having a Tungsten Filament of Larger Diameter. This patent was held to be valid in an infringement suit in *General Electric Co.* v. *Nitro-Tungsten Lamp Co.*, 261 F. 606 (1919) and 266 F. 994 (1920). In the view of the courts, the idea of a "gas-filled" lamp with a large filament was a "meritorious" invention, for the arrangement made possible more and better light with the same amount of electric energy.

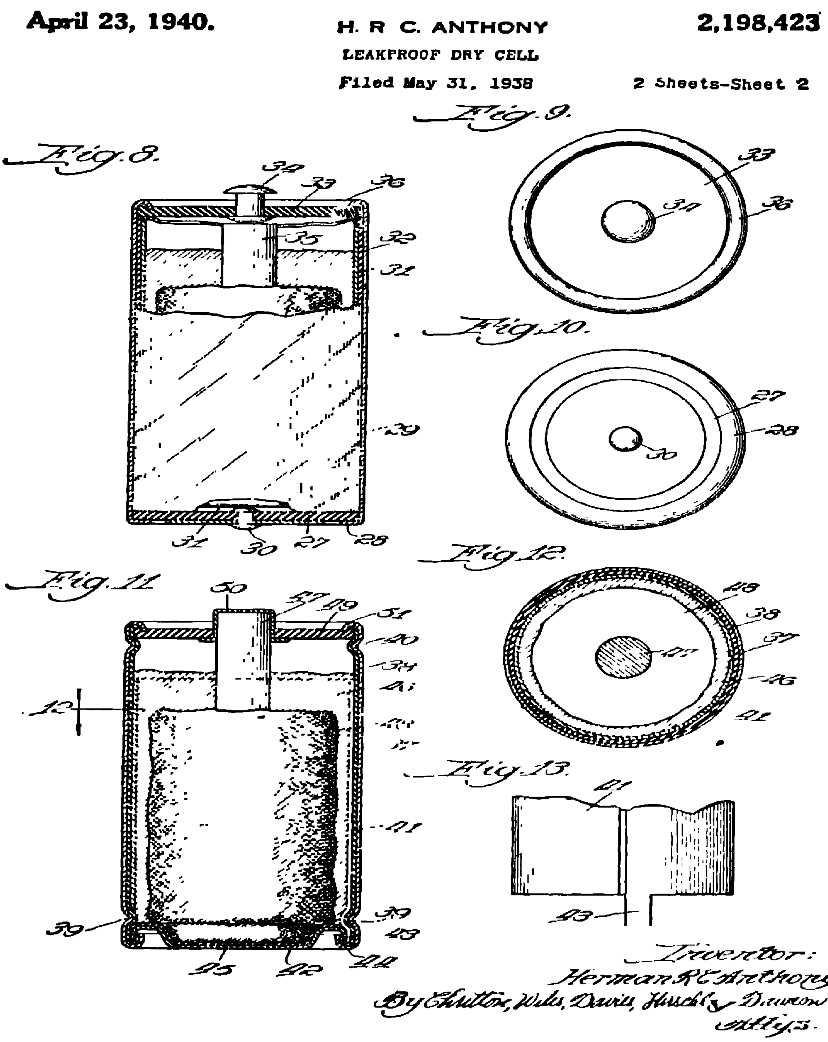

FIGURE 26. A Drawing of the Patent for a Leakproof Dry Cell. This sketch illustrates the method of producing a leakproof dry cell on which a patent was issued by the United States Patent Office in 1940. Although flashlight batteries had been made for some fifty years, no manufacturer had succeeded in producing a leakproof dry cell prior to the invention patented by Mr. Anthony. The Supreme Court upheld the validity of the patent in an infringement suit in *Goodyear Tire and Rubber Co.* v. *Ray-O-Vac Co.*, 321 U.S. 275 (1944), by majority vote, on the ground that the device prevented both leakage and swelling in a dry cell and was an advance in the prior art. Justices Black, Douglas, Murphy, and Jackson dissented, with Justice Black declaring that the use of solid containers to hold substances "pre-dated the dawn of history." The patent is one of the very few which has been held valid by the Supreme Court in recent years.

their own course in holding patents invalid. It seems likely, therefore, that any substantial reduction in the percentage of patents declared invalid in the future will depend mainly upon changes in the economic and political climate which surrounds the courts.

The persons most severely injured by the action of the federal courts in declaring so many of the patents litigated to be unenforceable are small business firms and independent inventors. A supercorporation, having large financial resources, can threaten a small concern with infringement suits and force it to pay costly royalties for the use of patents of doubtful validity. It can also use its financial power to force a small business to sell or forgo the use of patents whose validity can be proved only by expensive litigation. All too often, it is said, patent controversies are determined not by the merits of the case but rather by the financial power of a company to "sweat it out."

There is general agreement among patent authorities that if our patent system is to fulfill its essential functions, steps will need to be taken (1) to provide a greater degree of uniformity in the standard of invention followed by the Patent Office and the standard followed by the courts and (2) to reduce in some way the great expense involved in testing the validity of patents.

USE OF PATENT RIGHTS TO CONTROL AN INDUSTRY

Very often there are several alternative ways of producing a product—such as gypsum wallboard, which is a core of gypsum between two paper liners. Frequently, moreover, patents cover only one aspect of the total productive process—i.e., one way of folding the paper over the edges of gypsum wallboard. Since rival processes exist, dominant enterprises in their drive for profits are led to bring rival patents or rival enterprises under their control *so as to monopolize an industry.*

The chief abuses in the use of patents in the American patent system, it is generally agreed, arise in the activities of a patent owner or owners to monopolize the sale of a given class of goods. Such efforts usually take form in (1) the restrictive conditions imposed by a patent owner upon a licensee who arranges to use a patent, (2) the restrictive agreements made by competitors in pooling or interchanging their several patent rights, and (3) the practice of a dominant producer to buy up and acquire a control over all or a large part of the patents in a given field of production. We shall now consider these various business arrangements and the attitude of the law toward them.

The Imposition of Restrictive Conditions on a Licensee

A patent owner may sell his invention, use it himself, or license others to share its privileges. Very often a patent owner finds it advantageous to

permit one or more competitors to use a patent, with or without payment of a royalty fee. Such action is usually dictated by considerations of reciprocal favor and private advantage. It may be that a patent owner would like to secure the use of certain patents from a rival firm. In some cases, a patent owner may grant a license to a competitor in order to avoid the possible problem of patent infringement and the need to test the validity of his patent in the courts. This procedure also is often practiced reciprocally. A patent owner may likewise grant a competitor a license with the thought of keeping him from developing an alternative process.

In making a license contract, a patent owner typically includes terms and conditions which restrain competition between himself and the licensee in the sale of the patented products. The restrictions imposed may take many forms. A patentee may require a licensee to confine his sales to a certain area or to a certain type of product. Tying clauses requiring a licensee to buy unpatented materials from the patentee are frequently used. The most common restrictive provisions apply to the prices which a licensee may charge for the products made and sold according to the patented formula. Other restrictions include those placed on the quantity and quality of the goods produced.

The General Electric Case. A leading case involving the restriction of competition between a patentee and a licensee was the General Electric case decided in 1926. The facts of the General Electric case were that the defendant, General Electric Company, owned patents covering the manufacture of certain types of electric lamps. General Electric, the patentee, licensed the Westinghouse Company to make lamps under this patent on condition that it sold only at prices fixed by the patentee. The government brought suit against the two companies, charging that the agreement violated the Sherman Act.

In considering the case, the Supreme Court summarized the main issue as follows: "If the patentee . . . licenses the selling of the articles, may he limit the selling by limiting the method of selling and the price?" The Court answered in the affirmative, stating: "We think he may do so *provided the conditions of sale are normally and reasonably adapted to secure pecuniary reward for the patentee's monopoly*. . . . When the patentee licenses another to make and vend and retains the right to continue to make and vend on his own account, the price at which his licensee will sell will necessarily affect the price at which he can sell his own patented goods. It would seem entirely reasonable that he should say to the licensee, 'Yes, you may make and sell articles under my patent but not so as to destroy the profit that I wish to obtain by making them and selling them myself.' "[6]

The decision in the General Electric case, most legal authorities agree, looked at a patent-licensing arrangement entirely from the point of view of

[6] *U.S.* v. *General Electric Co.*, 272 U.S. 476, 490 (1926). Italics supplied.

the patent owner and the licensee. Private advantage rather than public welfare was made the test for the legality of a license agreement. From an economic standpoint, it may be said that a patent owner is entitled to receive a reasonable royalty for the use of his patent by another. However, the licensee should ever be free to manufacture and sell his products at prices which reflect *his* efficiency and *his* estimate of market forces.

EFFORTS TO LIMIT THE SCOPE OF THE GENERAL ELECTRIC DECISION. Upon the basis of the General Electric decision, the view developed that one who uses patents as a basis for price-fixing arrangements is by that fact exempted from the laws against restraint of competition. Patents and licensing agreements, it was believed, insured a blanket exemption from the Sherman Act for price-fixing purposes. The use of patents for making price agreements thereupon spread rapidly in many lines of business. The General Electric case, it may be noted, involved a *single* license from a *single* licensor to a *single* licensee on a *single* product. In adopting the principle of the decision, however, business firms holding patents arranged price-fixing agreements with *all* or most of their competitors in a given line of business.

The Masonite Case. The facts in the Masonite case (1942) were that a group of competitors making hardboard and insulation board became involved in a dispute over the validity of certain patents used in manufacturing these building materials. As a method of settling the dispute, the competitors entered into agreements with one another which provided that (1) Masonite would make all the hardboard in the industry; (2) that competing manufacturers would distribute this product on an "agency" basis, giving Masonite a guarantee of payment; and (3) each would adhere to the prices and terms fixed by Masonite. The government charged that the combination in the hardboard industry was a price-fixing conspiracy and illegal per se under the Sherman Act.

The basic theory underlying the Masonite case was that it was illegal for a group of competitors or potential competitors, through the device of agency contracts, to agree to suppress and eliminate competition among themselves. If such an agreement were lawful, there would be nothing to prevent a group of manufacturers *of any given product* from deciding that they could more profitably concentrate their production in the hands of one single company and have all the other companies designated as agents to distribute those products at prices fixed by the manufacturing company. In this way, competition in the production as well as in the distribution of the product would be effectively eliminated.

The defendants contended that since Masonite had the exclusive patent right to produce Masonite hardboard, it was permissible for Masonite to agree with its competitors that they would become agents of Masonite. The Court assumed that Masonite competitors were actually agents of Masonite but held that an agreement among virtually all competitors, or potential competitors, in an industry which effectively limited and restrained com-

petition among them, was violative of the Sherman Act whether it was under the guise of an agency relationship or otherwise.[7]

The Line Material and Gypsum Cases. The Line Material and Gypsum cases decided by the Supreme Court in 1948 involved the issue of whether a patentee may fix the prices at which *multiple* licensees must sell a patented product. The government asked the Court in both cases to overrule the General Electric case on the grounds that (1) price-fixing agreements are illegal per se under the Sherman Act and (2) a patent right confers only the right to exclude competitors—not to join with them in price fixing. In the Line Material case, a majority of the Court held that it was not necessary to overrule the General Electric case in order to decide against the patent-licensing arrangement presented in that case. However, four of the justices sharply attacked the 1926 decision. Although the General Electric decision on patent-licensing agreements still stands, the majority indicated in both the Line Material and the Gypsum cases that it will look with disfavor on such agreements containing restrictive provisions when made *with more than one licensee.*

The facts in the Line Material case were that two principal producers of fuse cutouts, used in protecting an electric circuit from a short circuit or overload, made a cross-licensing agreement for the use of an essential, complementary patent held by each company. The agreement provided that each patentee would fix the price on the product made by the licensee. The two companies—Line and Southern—agreed further that Line could license other producers to use the patents provided the licensees maintained the prices fixed by Line. The Supreme Court held that the agreement between Line and Southern for the cross-licensing of patents and the reciprocal fixing of prices was illegal per se. According to Justice Reed, speaking for the Court, "The merging of the benefits of price-fixing under the patents restrains trade in violation of the Sherman Act in the same way as would the fixing of prices between producers of non-patentable goods. . . . When patentees join in an agreement as here to maintain prices on their several products, that agreement, however advantageous it may be to stimulate the broader use of patents, is unlawful per se under the Sherman Act. It is more than an exploitation of patents. There is the vice that patentees have combined to fix prices on patented products."[8]

The Gypsum Case. The Gypsum case, decided the same day as the Line Material case, involved a price-fixing arrangement among the licensed producers of gypsum wallboard, a product made in accordance with a number of patents. The facts of the case were that the dominant producer, the United States Gypsum Company, following several patent controversies with competitors, entered into a separate patent-licensing and price-fixing agreement with each of the principal producers of gypsum wallboard in the

[7] *U.S.* v. *Masonite Corp.*, 316 U.S 265 (1942).

[8] *U.S.* v. *Line Material Co.*, 333 U.S. 287, 311–315 (1948).

United States. Since each agreement was an individual one, the company maintained that upon the basis of the General Electric case its license arrangements were legal. The government, however, charged a violation of Sections 1 and 2 of the Sherman Act and pointed especially to the use by the company of a subsidiary corporation—Board Survey, Inc.—to check on the prices of the various licensees in order to insure complete compliance with the prices dictated by Gypsum.

The Supreme Court upheld the government in the Gypsum case and declared that a series of individual licensing arrangements did not come within the General Electric case. "Lawful acts," said Justice Reed, "may become unlawful when taken in concert." In particular, Justice Reed emphasized that "the General Electric case affords no cloak for the course of conduct revealed in the voluminous record in this case. That case gives no support for a patentee, acting in concert with all members of an industry, to issue substantially identical licenses to all members of the industry under the terms of which the industry is completely regimented, the production of competitive unpatented products suppressed, a class of distributors squeezed out, and prices on unpatented products stabilized."[9]

There is general agreement among legal authorities that the effect of the Line Material and Gypsum cases is to restrict sharply the extent to which a patent owner can now use his patent as a device for monopolizing an industry by licensing other producers. The government has not fully won its principle that *all* price-fixing agreements shall be tested by the Sherman Act, but the sharply divided Court in the Line Material case gives hope that it may some day win a recognition of this rule.

The New Wrinkle Case. Since the Line Material and Gypsum cases, the Antitrust Division has continued to press for the invalidation of price fixing in patent licensing plans. The New Wrinkle case (1952) involved two competitors who had been engaged in litigation over their respective patents covering the manufacture of wrinkle-finish enamels. In settling their dispute, these firms organized a new company, jointly owned, to hold the rival patents. The new company thereupon licensed substantially all—over 200—manufacturers of wrinkle finishes in the United States. The licensing arrangements made with these manufacturers contained price-fixing provisions. The Court condemned the scheme, declaring: "We see no material difference between the situation in Line Material and Gypsum and the case presented by the allegations of this complaint. An arrangement was made between patent holders to pool their patents and fix prices on the products for themselves and their licensees. The purpose and result plainly violate the Sherman Act."[10]

The International Salt Case. The Supreme Court has consistently held in a long line of cases that a patent owner cannot use his patent to control the

[9] *U.S.* v. *U.S. Gypsum Co.*, 333 U.S. 364, 400 (1948).
[10] *U.S.* v. *New Wrinkle, Inc.*, 324 U.S. 371, 380 (1952).

sale of unpatented products by the use of tying clauses in patent agreements. The International Salt case, decided in 1947, held in fact that the licensing of patented devices on condition that certain unpatented materials be used with the patented devices is illegal per se. The facts in the Salt case were that the International Salt Company had leased its patented machines for dispensing salt in industrial processes—such as fish canning and meat packing—only on condition that the licensees would purchase supplies of unpatented salt from the company. Some 900 of such leasing contracts were found to be operative. The government charged that the tying clauses violated Section 1 of the Sherman Act and Section 3 of the Clayton Act. The company in its reply contended that tying clauses were not illegal per se and further that its contracts were not unreasonable restraints upon competition.

Justice Jackson, speaking for the Court in the International Salt case, held that a patent confers only a limited monopoly on the invention itself, and no right at all to restrain the trade of an unpatented product. In his words, "By contracting to close this market for salt against competition, International has engaged in a restraint of trade for which its patents afford no immunity from the antitrust laws. . . . Not only is price-fixing unreasonable, per se, but also it is unreasonable, per se, to foreclose competitors from any substantial market. . . . Under the law, agreements are forbidden which 'tend to create a monopoly,' and it is immaterial that the tendency is a creeping one rather than one that proceeds at full gallop; nor does the law await arrival at the goal before condemning the direction of the movement."[11]

Patent Pools and Cross-Licensing as Devices for Controlling an Industry

A second major device used by patent owners for controlling an industry is that of restrictive agreements made by competitors for the interchange of their patents, either by the use of a "patent pool" or by a more limited cross-licensing arrangement. A patent pool is an arrangement by which two or more patent owners throw their individual patents into a pool and receive in return a license to use all the patents in the pool. In some instances, patent pools may be in the public interest. Patents frequently cover *improvements* on basic inventions; and if various producers cannot use the latest technology, the public as well as individual producers suffer.

There is nothing in patent pools, as such, which makes them violative of the Sherman Act, for the mere pooling of patents does not mean that a producer gives up his freedom to manage his business independently. The abuses of patent pools arise when (1) the pool is closed to other responsible producers or is made available to them only upon the payment of excessive royal-

[11] *International Salt Co.* v. *U.S.*, 332 U.S. 392, 395 (1947).

ties and (2) the pool uses its patents to license others, or its own members, on condition that they will maintain prices or operate only in certain territories or fields of operation. All such restrictive arrangements are contrary to the spirit of the antitrust laws.

A brief discussion of the Hartford-Empire case (1945) will serve to illustrate the abuses which sometimes arise in pooling arrangements, and also the corrective relief which the courts are now imposing on abused patents. The facts presented an appalling story in which the Hartford-Empire Company, in cooperation with other leading manufacturers of glassware, pursued a ruthless plan of litigation against patent owners in the glassware industry, "expensive beyond the dreams of the average man," to corral a control over a large part of the patents for making glassware. Thereupon Hartford-Empire and some eight other leading glassware manufacturers entered into an elaborate patent pool and cross-licensing system which gave the group an effective control over the entire industry. In 1938 the defendants had over 800 patents in the glass container industry centralized in their pool, and some 94 percent of the glass containers manufactured in the United States were produced on machines licensed under the pooled patents.

The licensee agreements made by the Hartford group with smaller manufacturers were highly monopolistic and restricted the quantity of containers they could manufacture, the prices they could charge, as well as the type, color, size, and weight of the glassware they could produce. The District Court found that as a result of the patent policies of the defendants—their acquisition and pooling activities, restrictive licensing plans, tying contracts, and continuous efforts to control product prices and royalty payments—price competition in the glassware industry had been suppressed, monopoly control attained, and further invention and technological progress discouraged. Upon the basis of these findings, the District Court held that the defendants were in violation of Sections 1 and 2 of the Sherman Act and Section 3 of the Clayton Act.

The case against the Hartford defendants was conclusive, and the main problem for the District Court was that of determining the appropriate relief. The most important provision of the decree dealing with patents was the stipulation that all the abused patents involved in the case be licensed royalty-free to any applicant, and that all future patents be licensed at reasonable royalties.

The defendants appealed the decree in the Hartford case to the Supreme Court, claiming that their patent rights had been improperly abrogated. In a comprehensive review of the decree, the Supreme Court in a four-to-three decision remanded the case with numerous significant changes. The provision of the decree requiring that the abused patents be licensed royalty-free was reversed on the ground that such harsh treatment was unnecessary in the dissolution of the combination. In place of this requirement, the Supreme Court held that all existing and future patents should be licensed

to all applicants at reasonable royalties. The majority of the Court also reversed the portion of the decree enjoining the defendants from suppressing patents. In the view of the majority, a patent owner has the legal right to use or not to use his invention as he may desire.[12]

The government was quite disappointed in the modifications of the decree made by the Supreme Court. A careful study of the problems of creating competition in patent-controlled fields had convinced the government that abused patents must be made available to all, royalty-free. The extra cost placed upon a new competitor in having to pay royalties to the established firms on many patents—some, perhaps, of doubtful validity–it was believed, would impose a serious barrier to competition. The problem of determining reasonable royalties, moreover, was looked upon as presenting many new difficulties which the government and the courts were not prepared to handle.

Bilateral or Multilateral Cross-License Agreements. The essential idea of a patent pool is that each member puts *all* his own patents into a pool and gets in return a license to use *all* the other patents in the pool. A second type of cross-licensing arrangement is that of an agreement between competitors in which each grants the other an exclusive license to use *designated* patents, usually with specified territorial limitations. This sort of plan is commonly adopted in the international field, in which dominant firms in different countries having patents on similar formulas or methods granted by their respective governments agree (1) to interchange patents in a given field, as well as all future improvements and technical knowledge; and (2) to divide sales territories in designated portions of the world.

An example of a typical international cartel involving a multilateral cross-licensing patent agreement is found in the National Lead case, decided by the Supreme Court in 1947. The facts of the case were that around 1920 two Americans, a Frenchman, and a Norwegian each invented and secured patents on processes for converting titanium, the ninth most abundant element in the earth, into a white pigment for use in making paints, vitreous enamels, rubber goods, paper, glass, and many other products. The National Lead Company secured the American patents, a Norwegian company bought the Norwegian patents, and du Pont subsequently acquired the French patents. Thereupon, the three companies entered into an elaborate conspiracy to interchange present patents, to fix prices and divide sales areas, and to provide one another with future patents and a knowledge of improvements in technology.

As a result of the monopolistic arrangements sponsored by National Lead, du Pont, and their foreign associates, the combination was able to exercise complete world-wide control over the manufacture of titanium and over its sales and prices in designated trade areas. The United States government

[12] *Hartford-Empire Co.* v. *U.S.*, 323 U.S. 386, 415 (1945).

charged the American defendants with a violation of Sections 1 and 2 of the Sherman Act and asked for the creation of competition in the American industry.

Judge Rifkind, in the District Court, found the American defendants guilty of the violations charged, declaring that "when the story is seen as a whole, there is no blinking the fact that there is no free commerce in titanium. Every pound of it is trammelled by privately imposed regulation. The channels of this commerce have not been formed by the winds and currents of competition. They are, in large measure, artificial canals privately constructed."[13] In the decree awarded to the government, the District Court directed that there should be compulsory licensing of all present patents, as well as of all patents acquired within five years, at "reasonable" royalties. The decree also provided that technical information, along with the patents, be disclosed at reasonable prices. The government had asked that the abused patents be made available royalty-free, but this relief was not granted. The District Court stated that it would have liked to have granted this request but felt that it was controlled by the views of the Supreme Court—as expressed in the Hartford-Empire case.

Upon appeal to the Supreme Court, the government requested that the Hartford-Empire case be overruled on the grounds that (1) abused patents should be made unenforceable and (2) the requirement of reasonable royalty licensing arrangements is inadequate and unworkable. In the view of the government, the provision that a newcomer must pay "reasonable" royalties would place him at a distinct competitive disadvantage and enable National Lead and du Pont to maintain their dominance in the field.

The Supreme Court in a four-to-three decision, however, refused to grant the request of the government. In the words of Justice Burton, speaking for the majority, "We feel that, without reaching the question whether royalty-free licensing or a perpetual injunction against the enforcement of a patent is permissible as a matter of law in any case, the present decree represents an exercise of sound judicial discretion."[14] The majority thus reaffirmed its view in the Hartford-Empire case that abused patents should be licensed to all, but at "reasonable" royalties. Justice Burton indicated further in the majority opinion that a cross-licensing arrangement between large corporations in principle is illegal unless the patents are made available to others on a "reasonable" basis.[15]

[13] *U.S.* v. *National Lead Co.*, 63 F. Supp. 513, 521 (1945).

[14] *U.S.* v. *National Lead Co.*, 332 U.S. 319, 338 (1947).

[15] Patents have been made available royalty-free or dedicated to the public in a number of *consent* decrees. Thus, in the *A. B. Dick Mimeograph* case, the decree provided that the company forthwith "take such steps as may be necessary to dedicate, transfer, and assign to the public all United States Letters Patent . . . reading on or claiming stencil duplicating machines, stencils, or stencil duplicating supplies or raw materials" (*U.S.* v. *A. B. Dick Co.*, *Final Judgment*, Civil Action No. 24188, District Court of the United States for the Northern District of Ohio [1947]).

The Concentration of Patents in the Hands of a Single Owner to Control an Industry

The third—and final—way in which patents are sometimes used to control an industry is based upon the concentration of patents in the hands of a single owner. When a firm secures dominant financial size—usually by means of merger—it also secures large financial power. This power makes it possible for the firm to (1) acquire large numbers of patents by purchase and research and (2) discourage others by instituting continuous and financially embarrassing patent suits. Independent inventors soon find that the dominant company is the most likely buyer for their inventions, and the company becomes able to buy new patents largely on its own terms. The process of patent acquisition, once begun, grows like a rolling snowball, and the dominant company finds that it is able to control an industry by controlling access to the most efficient and most improved methods of production.

The problem of patent amassment is accentuated by the fact that a large fraction of the patents issued by the Patent Office are never used. It has been estimated by patent experts that probably not more than 45 percent of all patents issued in the United States are ever used. Patents acquired, but not used, make it possible for a large corporation not only to put new technology "on ice," but also to bring infringement suits against concerns seeking to employ alternative methods. Today, a concern planning to enter a given technical field must spend at least $100,000 in making a patent search to determine whether or not its method has been covered in the claims of a prior patent. This is a great deterrent to small business firms.

Thus far, the government has made only a small beginning in the task of investigating and destroying the monopoly power which is secured by a concentration of patents in the hands of a single owner. Section 2 of the Sherman Act provides ample authority for the government to use in proceeding against large-scale patent owners and hoarders. As a supplementary procedure, it has been suggested that Congress should levy a substantial tax on all unused patents.

REMEDIAL MEASURES PROPOSED FOR CORRECTING ABUSES IN THE AMERICAN PATENT SYSTEM

In view of the many abuses which characterize the American patent system, and also the fact that government has become the principal sponsor of research, it is sometimes suggested that the use of patents to improve technology is an "outworn" and "outmoded" institution. Research at the present time, it is observed, is increasingly coming to be a cooperative undertaking; and the exclusive rights of the patent system are serving chiefly to make possible a concentration of technical knowledge in the hands of a

few large corporations, for use if they please, when they please, and to the extent that they please.

Proposals for correcting the abuses and other shortcomings currently found in the American patent system involve (1) a more vigorous enforcement of the antitrust laws, (2) a procedural change in the administration of patent law, and (3) basic changes in the substantive law on patents. Patent law reform, it may be noted, has been an urgent public need for decades, and there is little disagreement among independent patent authorities on basic remedial measures which should be adopted.

A Proposed Procedural Change

Public Hearings on the Issuance of Patents. At present, patent applications are kept secret until the patent is actually granted. This arrangement places the final burden of checking novelty and prior use upon the Patent Office. Some patent authorities believe that if the public were given an opportunity to supply pertinent information, the Patent Office could do a much better job of evaluation—on the principle that "all of us know more than some of us." The National Patent Planning Commission, for example, declares that "there should be some provision whereby information and facts bearing upon the validity of a patent can be brought to the Patent Office thereby giving it an opportunity to re-examine its decision to grant a patent and also to afford the public a full opportunity to challenge the validity and to bring about a revocation of an improperly granted patent."

It is possible that the proposal on public hearings would check the issue of invalid patents to the "independent" to a much greater extent than to large corporations. If a field is dominated by a few financial giants which "get along together," it is likely that objections would be offered only to the applications filed by a newcomer or an independent.

Proposed Changes in the Substantive Law on Patents

Adoption of a Uniform Standard for Invention. A basic problem in the American patent system which needs correction is the fact that the Patent Office and the courts do not use the same standards for testing inventions. It is widely recognized that the Patent Office grants far more patents than the courts will accept as representing invention. The result is continuous patent litigation. It is recognized that many practical difficulties are involved in working out a standard for invention which will be in the public interest. The problems, however, appear to be ones which can be solved by experts if they put their minds to it. Since the public interest is at stake, it is suggested that Congress should secure technical assistance on this matter from independent patent experts and from professors of law and engineering in our universities, for these men are in the best position to give objective advice and guidance.

Compulsory Licensing

The really controversial remedial measures suggested for the American patent system are those which call for a compulsory licensing of patents. Some authorities and investigating committees recommend a plan for the general compulsory licensing of all future patents; others propose the compulsory licensing only of patents which have been abused or suppressed. Large business corporations and their legal spokesmen are vigorously opposed to any and all forms of compulsory licensing.

In an appraisal of general compulsory licensing, Dr. Floyd L. Vaughan concludes that "compulsory licensing would be an effective means for dealing with industrial monopoly and restraint of trade, and for preventing conflict in the use of the latest technology."[16] Likewise, Dr. Victor Abramson states: "If it could be successfully administered, the public benefits which might be derived from the general compulsory licensing of patented inventions would indeed be many. Inventions would be unlikely to lie idle because of inertia, and even less so because of design. The owners of dependent inventions would have ready access to essential auxiliary technology. Since all could use the most advanced technology, production generally would be on a higher level and prices would reflect this fact."[17]

In a memorandum for the Senate Small Business Committee, Dr. Benjamin Gordon, staff member, has suggested that compulsory licensing may work to the disadvantage of small business firms, for they could then be required to share sources of strength which they might develop. As an alternative, he proposes that compulsory licensing be limited to large corporations, owning thousands of accumulated patents. In his view, it could be provided that when any corporation which has dominance in a particular industry (in terms of assets or sales) applies for a patent which would presumably tend to increase its market control in that industry, it would be required to issue licenses on reasonable terms.

The principle of compulsory licensing of patents was adopted by Congress in the Atomic Energy Act of 1946 with respect to patents granted for the *nonmilitary* use of atomic energy. It is possible for inventors to secure patents on the nonmilitary utilization of atomic energy, but the Commission is authorized to declare any such patent "affected with a public interest" and provide for its licensing on a reasonable royalty basis. If the patent owner and licensee cannot agree on a royalty fee, the Commission is authorized to determine it. Congress adopted the principle of compulsory licensing in order to make the peacetime benefits of this discovery widely available to all.

[16] Floyd L. Vaughan, "Patent Policy," *American Economic Review, Papers and Proceedings*, May, 1948, p. 227.

[17] Victor Abramson, "The Economic Bases of Patent Reform," *Law and Contemporary Problems*, Spring, 1948, pp. 350-351.

DIRECT SPONSORING OF RESEARCH BY GOVERNMENT

In most cases today, governments do not rely upon patents alone for getting the inventions and discoveries which a nation needs for its economic and military welfare. A patent stimulates private invention, and private invention today is largely conducted by business corporations for business profit. Profit is a legitimate motive, but profit making does not always lead to undertakings which are in the greatest public need. It is for this reason that governments themselves are now becoming important sponsors of industrial research and important holders of patents (see also Chapter 6, pages 112–113).

An anomalous aspect of the industrial research sponsored by various federal agencies in the United States is the absence of a uniform system among the agencies for acquiring the patents which grow out of the expenditure of federal funds. A large part of the research sponsored by the federal government is carried out by private industry under the direction of some governmental agency. The Department of Agriculture, the Tennessee Valley Authority, and the Atomic Energy Commission generally retain a control over the patents which are developed by private contractors. The Department of Defense, on the other hand, which spends about 70 percent of all federal research and development money, gives away to the contractors the commercial rights to products resulting from government-financed research and development. When the government owns patents, its general policy is either to dedicate them to the public or to issue royalty-free licenses to all applicants.

CONTROL OF TECHNOLOGY SECURED BY USE OF FEDERAL FUNDS

The question of the policy which the government should follow with respect to the ownership of patents developed with federal funds is a highly important one. Private corporations, of course, are eager to secure a control over all inventions they develop in research activity financed by the government. Moreover, as long as they own the large laboratories which are necessary for use in conducting government research, they are in a strong position to insist upon contracts giving them the commercial rights to the resulting patents. During World War II, in particular, it is reported that the large corporations were unwilling to accept government research contracts which did not give them commercial rights to all patents developed in the course of such research.[18]

[18] United States Department of Justice, *Investigation of Government Patent Practices and Policies* (Washington, 1947), Vol. 2, pp. 299, 302, 463.

Upon the basis of an exhaustive three-year study of patents and patent regulation, the Attorney General in May, 1947, submitted a comprehensive report recommending that all technological developments financed by federal funds should be owned or controlled by the government.

Thus far no action has been taken in regard to inventions made in the course of government contracts with private industry, research or otherwise. Each federal agency is free to prescribe its own policy. By and large, the agencies have continued to follow the practices described in the Attorney General's report. This means that with few exceptions the federal agencies leave ownership of inventions to private corporations, subject to a license to the government.

Today, probably over 80 percent of all federal research contracts (in dollar terms) give away commercial rights to contractors. Many people in government are continuing to question these "give-away" programs, and the Senate Small Business Committee is making continuing studies of the problem. Defense research has resulted in the creation of many new products and the accumulation of technology with highly profitable commercial applications. The disproportionate share of total industrial research and development in the largest firms foreshadows greater concentration in the future for the benefits derived from government-financed research, in addition to the profits resulting from the performance of research and development and procurement contracts.

In the opinion of many legal and economic experts, the federal government itself should secure all patents developed in the course of the research which it finances. Such patents can then be licensed royalty-free to all applicants, and the benefits of modern science can be made available to all enterprisers for competitive development.

13

The Federal Trade Commission and Prevention of Unfair Trade Practices

The purpose of the present chapter is to analyze the work of the Federal Trade Commission, an administrative agency charged, in the main, with the duty of preventing "unfair methods of competition" and "unfair or deceptive acts or practices" in interstate commerce. Competition in business, experience shows, gives rise to unfair trade practices, including deceptive advertising. Ground rules for competition, it has been found, are as essential in business as they are in sports. The work of the Federal Trade Commission is concerned with rules by which society seeks to govern businessmen.

BACKGROUND FOR THE FEDERAL TRADE COMMISSION ACT (1914)

The evidence presented in the Standard Oil and American Tobacco cases showed clearly that cutthroat competition was a principal tool used by mergers to eliminate independents and to extend their area of control. Although the Supreme Court condemned the "intent and purpose" of these mergers to secure monopoly control, it failed to declare that their methods of competition, as such, were unfair. A considerable part of the business community became greatly disturbed over this fact; and demands were made upon political leaders to provide legislation identifying and prohibiting the *means* of unfair competition, *without regard to intention or motive*. In the political campaign of 1912, both the Republicans and the Democrats promised new legislation to prohibit unfair competitive practices. The general view of leaders in both parties was that if the tools of incipient monopoly could be outlawed, the further and nation-wide development of monopoly could be prevented.

In the work of the House and Senate committees, general agreement was

reached that (1) the principle of fair competition should stand as the basic economic policy for the nation and (2) unfair competition should be prohibited in order to nip monopoly in the bud—"to catch the weed in the seed." According to the House Committee, "The most certain way to stop monopoly . . . is to prevent unfair competition."[1] Several attempts were made to define the term "unfair competition" and to enumerate the practices which were deemed to be unfair. The prevailing view, however, was that there should be a blanket prohibition of unfair competition, and that the determination of acts falling within this category should be left to a special trade commission. According to the House committee, "It is impossible to frame definitions which embrace all unfair practices. There is no limit to human inventiveness in this field. Even if all known unfair practices were specifically defined and prohibited, it would be at once necessary to begin over again. If Congress were to adopt the method of definition, it would undertake an endless task."

The legislative history of the Federal Trade Commission Act shows clearly that the Commission was created to consider unfair business practices which are short of being Sherman Act violations. Conspiracy, undue restraint of trade, and attempts to monopolize were condemned under the Sherman Act. Business behavior which lessened competition and impeded the trade of others, however, was not so condemned. In Congressional consideration of the Federal Trade Commission Act, Representative Carlin declared: "There must be actual restraint of trade under the Sherman law to bring any one under either its civil or criminal processes. Under this bill, there has to be only a lessening of competition. Competition may be lessened without restraint of trade. Competition may be lessened without an attempt to monopolize. Competition may be lessened without conspiracy."[2]

Basically, "unfair competition" is an economic concept, and the task of the Commission is to fashion the law to condemn behavior which is unfair from an economic standpoint. In an economic sense, unfair competition means any practice or method of competition employed *by some sellers* which prevents an enterprise from surviving or expanding on the basis of efficiency. Some examples of unfair methods of competition are false advertising; disparagement of a rival's merchandise; bribing customers' employees; and the practice of price discrimination which injures competition.

THE FEDERAL TRADE COMMISSION ACT

The general views of Congress on the prohibition of unfair methods of competition were embodied in the Federal Trade Commission Act, which

[1] *Conference Report, Federal Trade Commission*, 63rd Congress, second session, House Report 1142, September 4, 1914, p. 19.
[2] *Congressional Record*, May 26, 1914, Vol. 51, p. 9271.

was signed by President Woodrow Wilson on September 26, 1914. The principal provisions of this legislation may be summarized as follows:

1. Provision is made for the creation of a Federal Trade Commission of five members to be appointed by the President, with the advice and consent of the Senate, for terms of seven years. No more than three of the commissioners shall be members of the same political party.

2. The heart of the Federal Trade Commission Act is Section 5, which prohibits "unfair methods of competition" in interstate commerce. In summary form, Section 5 states that "*unfair methods of competition in commerce are hereby declared unlawful.* . . . Whenever the commission shall have reason to believe that any such person, partnership, or corporation has been or is using any unfair methods of competition in commerce, and *if it shall appear to the commission that a proceeding by it in respect thereof would be to the interest of the public*, it shall issue and serve . . . a complaint" (italics supplied).

Section 5 was early interpreted by the courts to mean that a questionable business practice may be attacked by the Commission only when there is a "specific and substantial" *public* interest in the prevention of the particular practice involved. Thus, the Klesner case (1929) involved a controversy between two sellers of lamp shades over the use of the firm name "The Shade Shop." Klesner adopted the name although it was used by a competitor only a short distance away, and the Commission ordered him to cease and desist its use. The Supreme Court dismissed the case on the ground that the interest concerned was primarily a private one. In the view of the Court, there must be a public concern in the controversy between competitors, as would be true if a case involved "flagrant oppression of the weak by the strong."[3] Controversies which are private in nature, without a substantial public interest, are matters of private rights and remedies to be handled by the civil law in private suits.

A further important interpretation of Section 5 was made in the Raladam case, decided in 1931. The facts of this case were that the Raladam company manufactured and sold "an obesity cure," which it advertised as being safe, effective, and convenient to use. The Commission found that the product contained a dangerous drug which could not be safely used except under medical direction and advice. A cease-and-desist order was issued, and the company appealed the case, claiming that unfair competition was not involved. The Supreme Court agreed with the Commission that the advertisements were "dangerously misleading," and that the public had an interest in preventing the use of such methods. Nevertheless, the Court ruled against the Commission for the reason that the injurious methods *had not injured a competitor.* Unfair competition, the Court stated, implies injury to a competitor.[4]

3. The need for providing *consumers* with protection against unfair and

[3] *FTC* v. *Klesner,* 280 U.S. 19, 28 (1929).

[4] *FTC* v. *Raladam Co.*, 283 U.S. 643, 652 (1931).

injurious practices led to the enactment in 1938 of the Wheeler-Lea amendment to the Federal Trade Commission Act. By the terms of this legislation, Section 5 was amended to prohibit "unfair or deceptive acts or practices" in interstate commerce. In the House report on the proposed amendment to Section 5, it was stated: "By the proposed amendment to Section 5, the Commission can prevent such acts or practices which injuriously affect the general public as well as those which are unfair to competitors. In other words, this amendment makes the consumer, who may be injured by an unfair trade practice, of equal concern, before the law, with the merchant or manufacturer injured by the unfair methods of a dishonest competitor."[5]

4. Section 6 of the Federal Trade Commission Act empowers the Commission to collect and make available to the President, Congress, and the public factual data with respect to "the organization, business, conduct, practices and management of any corporation engaged in commerce, excepting banks and common carriers." This section of the act serves a very useful purpose. The investigations of the Commission have covered the gas and electrical utilities, the telephone industry, meat packing, tobacco processing, the oil industry, chain stores, farm implements, the basing-point system, resale price maintenance, mergers, and international cartels. Many of these reports have proved to be highly significant and have provided the basis for new remedial legislation—for example, the Packers and Stockyards Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Antimerger Act of 1950.

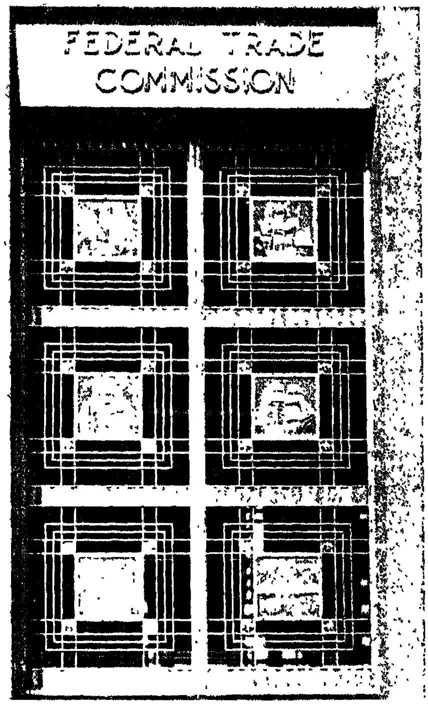

FIGURE 27. Entrance Doors to the Federal Trade Commission. If you go into business, it is likely that sometime you will confer with the FTC about someone's business conduct, possibly your own. As a citizen, too, it is possible that you may request action by the FTC against false advertising or unfair or deceptive practices, injurious to consumers.

[5] *Extension of Federal Trade Commission's Authority over Unfair Acts and Practices and False Advertising*, Committee on Interstate and Foreign Commerce, 75th Congress, first session, House Report 1613, August 19, 1937, p. 3.

5. Sections 12 to 15 of the Federal Trade Commission Act, as amended by the Wheeler-Lea Act, authorize the Commission to safeguard the public by preventing the dissemination of *false advertisements* with respect to foods, drugs, cosmetics, and therapeutic devices used in the diagnosis, prevention, or treatment of disease. The term "false advertisement" is defined as "an advertisement other than labeling which is misleading in a material respect." An amendment of 1950 adds that advertisements for oleomargarine or margarine cannot describe such oleomargarine or margarine as a dairy product. Persons who falsely advertise under Sections 12 to 15, with an intent to mislead and where the product is injurious to health, upon conviction by a district court may be fined up to $5000 and given a prison sentence of not more than six months, or both, for the first offense. Second and succeeding convictions carry a penalty of not more than $10,000 and not more than one year in prison or both.

The basic federal law with respect to food, drugs, and cosmetics is the federal Food, Drug, and Cosmetic Act of 1938, entitled "An Act to prohibit the movement in interstate commerce of adulterated and misbranded food, drugs, devices, and cosmetics, and for other purposes." This regulatory legislation, which replaced the original Food and Drug Act of 1906, is administered by the Food and Drug Administration. The federal Food, Drug, and Cosmetic Act prohibits *adulteration* and *misbranding*, whereas the Federal Trade Commission Act prohibits *false advertisement*. Strictly speaking, the sale of untruthfully labeled food and drugs, in many situations, is a form of unfair competition, and the Federal Trade Commission on occasion in the past has exercised a concurrent jurisdiction with the Food and Drug Administration. On December 5, 1946, however, the Federal Trade Commission announced that henceforth it would not institute proceedings against false labeling or branding in cases falling within the direct responsibility of the Food and Drug Administration. This action was taken to avoid conflict and duplication of effort.

OTHER ACTS ADMINISTERED BY THE FEDERAL TRADE COMMISSION

In addition to the Federal Trade Commission Act, the Commission administers the following measures:

1. Sections 2, 3, 7, and 8 of the Clayton Act (1914), as amended by the Robinson-Patman Act (1936). The Clayton Act provides that the Federal Trade Commission and the Department of Justice shall have concurrent jurisdiction over the enforcement of the provisions of the Clayton Act. Either agency may proceed against violators, and action is taken by the one which gets to it first. The pertinent sections of the Clayton Act, as amended by the Robinson-Patman Act, are those dealing with (1) various forms of price discrimination (Section 2); (2) exclusive dealing arrangements and

tying contracts (Section 3); (3) the acquisition by a corporation of stock or assets in competing enterprises (Section 7); and (4) certain kinds of interlocking directorates (Section 8). These sections will be discussed in detail in the following chapter.

2. The Export Trade Act of 1918, popularly known as the Webb-Pomerene Act. This legislation was discussed in Chapter 11.

3. The Wool Products Labeling Act of 1939, known as the "Truth in Fabrics" law. The purpose of the Wool Products Act is to protect manufacturers, merchants, and consumers against deception and unfair competition in articles which are made in whole or in part of wool. Before the enactment of this legislation, there were a great many abuses in the sale of woolen articles. Reused wool was sold as new wool; products sold as "all wool" often contained less than 5 percent wool, and "part wool" garments frequently meant only that woolen thread was used for stitching the buttonholes. The Wool Labeling Act was adopted as a result of the efforts of wool growers, consumers, and legitimate woolen manufacturers.

The act of 1939 provides that all products containing wool, except carpets, rugs, mats, and upholsteries, must disclose on a label attached to the merchandise the kind and percentage of each fiber contained in the product, including the respective percentages of "wool," "reprocessed wool," and "reused wool." The name of the manufacturer or distributor must also appear on the label, and the label must remain on the merchandise when it is delivered to the consumer. The Commission maintains a staff of inspectors to check on compliance by manufacturers, distributors, and retailers; and enforcement is conducted by means of conferences, stipulations, trade practice conferences, and use of cease-and-desist orders.

4. Certain provisions of the Lanham Trade-Mark Act of 1946. The Lanham Act provides that the Federal Trade Commission may apply to the Commissioner of Patents, whose office administers trademark legislation, for a cancellation of registered trademarks which are deceptive, immoral, or scandalous; which have been obtained fraudulently; or which are in violation of other provisions of the Lanham Act.

5. The McCarran Insurance Act of 1948 gives the Commission certain jurisdiction over the insurance business. This activity of the Commission is complex because it varies from state to state with variations in state law.

6. The Fur Products Labeling Act of 1951. This legislation is modeled after the Wool Products Labeling Act of 1939. Its purpose is to protect consumers and industry members against the misbranding, false advertising, and false invoicing of furs and fur products moving in interstate commerce. The widespread use of deception and false advertising in the sale of furs, such as use of the term "mink-blended coney" for rabbit fur, gave rise to demands within the industry for corrective legislation. Manufacturers and distributors are now required to attach labels on garments showing the name of the animal which produced the fur; country of origin; and whether the fur is bleached or dyed, or composed of paws, tails, bellies, or waste

furs. Retailers may substitute their own labels, but must retain the information from the original labels for a period of three years.

7. The Flammable Fabrics Act of 1953. By the terms of this legislation, prohibitions are placed on the manufacture for sale, the sale, the importation, or the transportation for sale of any wearing apparel which "is so highly flammable as to be dangerous when worn by individuals."

8. The Textile Fiber Products Identification Act of 1958. This legislation, which became effective on March 3, 1960, covers the labeling and advertising of all textile fibers not required to be labeled under the Wool Act. Its purpose is to protect purchaser-consumers by requiring a disclosure on the label and in advertising of the exact fiber content of all textile fiber products—other than wool—marketed in interstate commerce. Products covered include wearing apparel, draperies, floor coverings, yard goods, blankets, and sheets. All such products must have a label which shows the exact fiber content, expressed in percentages. Imported products must also carry on the label the name of the country in which the product was processed or manufactured.

ENFORCEMENT PROCEDURE UTILIZED BY THE FEDERAL TRADE COMMISSION

The Federal Trade Commission, we have seen, is empowered to prevent, in the public interest, (1) unfair methods of competition and deceptive acts and practices as forbidden in Section 5 of the Federal Trade Commission Act; (2) false and misleading advertising (Sections 12–15 of the Wheeler-Lea Act); (3) the prohibited practices in the Clayton Act (Sections 2, 3, 7, and 8), as amended by the Robinson-Patman Act; and (4) practices which are prohibited in the Export Trade Act, the Wool Products Labeling Act of 1939, the Fur Products Labeling Act of 1951, the Flammable Fabrics Act of 1953, and the Textile Fiber Products Act of 1958. In enforcing these regulations, the Commission utilizes three different procedures, namely, (1) individual and industry-wide conferences to secure voluntary compliance with rules of fair competition; (2) negotiation of stipulations with accused parties to abandon objectionable practices, and (3) legal action based upon the issuance of formal complaints. These three procedures are respectively called the cooperative method (or "administrative treatment"), the consent method, and the compulsory method for preventing the use of unfair trade practices.

Evidence for making complaints against business firms is secured by the Commission from its own investigations, from consumers, and often from the reports of one competitor against another. Approximately 10 percent of the cases selected are generated by the Commission's own investigations, and about 90 percent arise in the complaints of consumers, competitors, customers, and other governmental agencies.

Administrative Treatment

Letters of Discontinuance. The staff of the Commission handles many problems of unfair trade practices by contacting accused parties and discussing the issues with them. In so far as possible, the Commission seeks to settle such problems on a friendly basis. If the accused party will agree to discontinue the practice, and will sign a letter to that effect, the matter is often dropped at once. The policy is to give business a "break" if it is willing to cooperate. The "administrative treatment" differs from the "stipulation procedure" discussed below in that the letter of discontinuance need not be submitted to the Commission for approval. In the main, administrative treatment is used if (1) the accused is not a chronic violator and (2) the public interest can be protected by a statement that the practice will be stopped.

Trade Practice Conferences. If deceptive acts and practices are being rather widely used within a given industry, the Commission may invite trade members to attend a "trade-practice conference." The use of trade practice conferences was first instituted in 1919 by Commission members who sought to secure an acceptance of rules of fair competition by industry on a voluntary and cooperative basis rather than by legal prosecution. At the present time, the Commission is currently spending a substantial part of its budget on this type of work. The view of the Commission is that trade conferences afford a useful means for solving many problems of unfair competition on an industry-wide basis with a minimum of time and money.

Trade practice conferences may be called by the Commission upon its own motion or upon application by an industry group. In sponsoring a trade conference, the Commission invites industry members to meet with staff members from the Commission to discuss and develop rules for the conduct of business in the particular industry concerned. Public hearings are held on the proposed rules, and thereupon the rules adopted are submitted to the Commission for approval. Once they are approved, industry members are, in effect, put on notice that if they subscribe to and comply with the approved rules of business etiquette, they will to that extent be in harmony with the law.

It may be noted that only those rules are adopted which an industry group is willing to accept. Legal action, moreover, is never taken for the violation of a rule, as such, for the rules are advisory only. If complaints and an investigation indicate that a continuing violation exists, the Commission charges a violation of the basic statutes and not of a trade practice rule.

The rules formulated by a trade conference apply to recognized methods of unfair competition which trade members and the Commission agree should be specifically prohibited in the particular industry. Thus, in the Trade Practice Rules for the Wholesale Confectionery Industry, it is specified that business practices such as commercial bribery, defamation of competitors or

disparagement of their products, and coercion to fix prices are unfair trade practices.

Commission Policy on Administrative Treatment. The Federal Trade Commission has stated that its policy is not to dismiss cases by administrative treatment or to settle them by stipulation if the violations "involve intent to defraud or mislead; false advertisements of foods, drugs, devices or cosmetics which are inherently dangerous or where injury is probable; suppression or restraint of competition through conspiracy or monopolistic practices . . . violations of the Clayton Act . . . [or] where the Commission is of the opinion that such procedure will not be effective in preventing continued use of the unlawful methods, acts, or practices." The records indicate, however, that the Commission has used, and continues to use, the trade practice rule-making procedure for dismissing or suspending a variety of cases involving deception and discrimination.[6] How is this deviation to be explained? In part, the Commission's practice appears to reflect an effort to secure *industry-wide* correction of certain trade abuses. In part, however, the practice also reflects an apathy of various commissioners to an enforcement of the Clayton Act, as amended, in any sort of a thoroughgoing way.

Following the adoption of a set of trade practice conference rules, the Commission makes almost no investigation of industry compliance. Upon occasion, however, staff members of the Commission do contact trade members and seek to get them to abide by a trade practice rule. If a firm persists in violating the rule, the Commission may thereupon attempt to secure a stipulation on discontinuance or it may issue a formal complaint. A policy of counseling an industry group to "go and sin no more" provides little reason or compulsion for obeying the antitrust laws. Monopolistic and deceptive practices are highly profitable arrangements. If they are to be stopped, government, in most cases, must "step on someone's toes." This the trade practice conference procedure does not do.

Experience has shown that trade practice conference rules, at their best, are those which apply to problems of misrepresentation. In the formulation of definitions for such terms as "taffeta," "satin," "shrinkproof," "waterproof," "rainproof," and "gold-filled," Commission and industry cooperation has proved to be genuinely useful. It is a good plan to expose tentative definitions and standards to the cross fire of criticism in order to develop unexpected meanings and interpretations. Since the definitions and standards are to be applied to a particular industry group, it is proper for this criticism to come from those who are most intimately acquainted with the industry.

Stipulation Procedure

The Commission settles many cases of unfair competition by means of stipulations. This procedure gives a proposed defendant an opportunity to

[6] *Antitrust Law Enforcement*, Select Committee on Small Business, 81st Congress, second session, House Report 3236, January 1, 1951, pp. 30–32, 91.

agree with staff members of the Commission that the objectionable practice should be abandoned. If an agreement can be reached, the business firm signs a stipulation, an admission of the material facts and *an agreement* to discontinue the unlawful practice, and no formal complaint is issued. The agreement, however, must be approved by the Commissioners. It is also made a matter of public record, and the respondent is required to submit a report within sixty days on the manner in which he is complying with the agreement. If the stipulation is subsequently violated, the Commission proceeds by complaint and order.

The stipulation procedure adopted by the Commission has proved to be an effective method for correcting a large number of violations with a minimum expenditure of time and money. In general, up to the present time, the stipulation procedure has been largely confined to the settlement of cases of false and misleading advertising, many of which grow out of the Commission's continuous scrutiny of radio and periodical advertising.

The Settling of Cases by Legal Procedure

Section 5 (b) of the FTC Act and Section 11 of the Clayton Act, as amended, provide that the Commission "shall issue and serve . . . a complaint" whenever it shall have reason to believe that an unfair method of competition, a deceptive act, or a monopolistic practice is being used in interstate commerce. The settlement of cases by securing letters of a discontinuance, by the dismissal of cases upon acceptance of trade practice rules, and by the stipulation procedure, is thus an innovation not contemplated by the law.

In using the complaint procedure, the accused party (the respondent) is made a defendant in a formal legal proceeding conducted by the legal staff of the Commission. A *complaint* is issued against the defendant, and provision is made for a public hearing before a trial examiner (also called "hearing examiner"). Trial examiners are, in effect, judges. Under the Administrative Procedure Act they are independent of the Commission and its staff.

Proceedings before a trial examiner are conducted much like a court trial. The Commission and the defendants are both represented by their own attorneys. At the conclusion of the hearings, the trial examiner issues a report containing (1) his findings and (2) an "initial decision," i.e., a dismissal or a cease-and-desist order.

The decision of the trial examiner becomes the decision of the Commission thirty days after service upon the respondent unless (1) the respondent appeals the decision to the Commission, (2) the Commission postpones the effective date, or (3) the Commission, itself, decides to review the case. If the Commission reviews the case, its attorneys and those of the respondent file briefs with the Commission. Subsequently, a public hearing is held and each side argues the case orally before the commissioners. The commis-

sioners thereupon either (1) dismiss the complaint or (2) issue their findings of fact with an order to cease and desist from the unlawful practice.

Cease-and-desist orders, it may be noted, are negative instruments of control. They tell a respondent what he may not do; not what he must do. The Federal Trade Commission Act, *as interpreted by the Commission*, does not clothe the Commission with authority to direct and require "fair competition" or to prescribe a positive course of conduct.

A defendant may appeal a cease-and-desist order to the appropriate Court of Appeals. The Federal Trade Commission Act provides that "the findings of the commission as to the facts, if supported by testimony, shall be conclusive." The function of the Court, therefore, is one of making a final determination of the rules of law. The Court of Appeals may affirm, set aside, or modify the order of the Commission, and it may also require the Commission to secure further factual evidence. If a defendant secures an adverse judgment in the Court of Appeals, he has the possibility of a final appeal to the Supreme Court.

The Wheeler-Lea amendment provides that if a defendant under the Federal Trade Commission Act plans to appeal an order of the Commission, he must do so within sixty days or the order becomes final and binding. Final orders of the Commission are enforced by contempt proceedings initiated in a District Court by the Attorney General. If a continuing offense is proven, each day will carry a penalty *up to* $5000 per day, at the discretion of the judge.

Cease-and-desist orders issued by the Commission under the Clayton Act, as amended, also become final after sixty days unless they are appealed. Violations are punished by contempt proceedings; and a civil penalty up to $5000 for each day of continuing violation or for each separate offense may be levied by the court.

Consent Settlements—Default Orders

In an effort to save time and expense in settling formal cases, the Commission in 1951 adopted a modified cease-and-desist order procedure. If there appears to be a reasonable probability of reaching an agreement on a remedy, the parties may seek to negotiate a settlement. Thereupon, if agreement is reached, a regular cease-and-desist order is prepared which represents a settlement acceptable to the staff and the Commission, as well as to the respondent. This is called a "consent order."

There is little doubt that the new settlement procedure provides a speedy way for disposing of formal cases. It is possible, however, that in working out a consent settlement, the Commission may agree to *minimum* forms of relief in an effort to secure acceptance by respondents.

A further procedure to expedite the handling of formal complaints was adopted by the Commission in 1951. It is the practice of issuing "default orders." If a respondent fails to answer a formal complaint, or if he admits

all the material allegations, the trial examiner and the Commission, it is provided, shall enter a "default order." Prior to the adoption of this rule, the Commission's practice was to hold hearings on complaints even when respondents failed to file an answer or to appear at the hearings.

THE MEANING OF THE TERM "UNFAIR COMPETITION" UNDER SECTION 5

Section 5 of the Federal Trade Commission Act, as amended, we have seen, prohibits (1) unfair competition in relation to the activities of competitors and (2) unfair and deceptive acts and practices employed against consumers. In applying and interpreting Section 5, what meaning have the courts and the Commission placed upon the term "unfair competition"?

The decision of the Supreme Court in the Gratz case (1920) was a highly important one in marking out the meaning of the term "unfair competition." In this case, a majority of the Supreme Court developed the view that unfair competition includes (1) practices involving deception, misrepresentation, and fraud, which have long been condemned in the common law; and (2) practices "against public policy because of their dangerous tendency unduly to hinder competition or create a monopoly."[7] The Gratz case is significant because it indicated that the Court would include in the category of unfair competition concerted action *by competitors*. In most instances, the idea of unfair competition had been applied to any act or method which injures or *excludes* a competitor. Now the concept was coming to embrace the *inclusive* acts of competitors to suppress competition or to create a monopoly. This point of view was carried further by the Supreme Court in the Beech-Nut Packing case, decided in 1922. Here the Court held that a price-fixing scheme which had the effect of destroying competition was a form of unfair competition because it restrained "the natural flow of commerce and the freedom of competition in the channels of interstate commerce which it has been the purpose of all the antitrust acts to maintain."[8]

A further significant case developing the scope of the Commission's jurisdiction under Section 5 was the Pacific States Paper case, decided in 1926. This case was an action brought against a group of local trade associations, their members, and a regional association in the paper industry on the Pacific Coast. Each association, the record showed, prepared price lists which were circulated among association members and regularly observed by them in making sales to customers. The Supreme Court condemned the practice and held that any business procedure which has a tendency to lessen competition and to fix uniform prices is an unfair trade practice under the Federal Trade Commission Act. In its words, "An understanding express or tacit that the agreed prices will be followed is enough to constitute a transgression of the

[7] *FTC* v. *Gratz*, 253 U.S. 421, 427 (1920).

[8] *FTC* v. *Beech-Nut Packing Co.*, 257 U.S. 441, 454 (1922).

law."[9] Upon the basis of the Pacific States Paper case, in particular, the Federal Trade Commission has established its jurisdiction to proceed against any form of concerted action by competitors which hinders, restricts, or suppresses competition. *Thus, cases against concerted action on price, as well as individual acts in restraint of trade, may be brought by the Department of Justice under the Sherman Act or by the Federal Trade Commission under the FTC Act.*

ACTION BY THE FEDERAL TRADE COMMISSION AGAINST MISREPRESENTATION, DECEIT, AND RELATED PRACTICES

A second broad category of business practices which the Federal Trade Commission and the courts have held to be "unfair competition" includes misrepresentation, oppression, deceit, and fraud. The cases arising in this category are by far the most numerous, for they typically stem from the everyday activity of *individual* competitors. Business is a profit-making activity; and if there is profit in certain practices, some unscrupulous businessmen are led to employ them on the ground that "business is business." Fair competition is not a natural process which can be left alone to develop of its own accord. It is rather the end result of a large amount of government intervention to provide "rules of the game" to insure that competitive activity is in the public interest.

The list of unfair competitive practices shown in Table 23 is based upon the cease-and-desist orders which have been issued by the Federal Trade Commission from time to time since its establishment. Each category represents situations in which individual business firms have sought by a particular means to hinder, limit, or injure one or more competitors.

An example of the type of work done by the Commission in condemning unfair competition based upon misrepresentation and deceit is found in orders of the Commission against the General Motors Corporation and the Ford Motor Company. Each of these orders was upheld in the Courts of Appeal.[10] The business practice challenged by the Commission in these cases was one of advertising a so-called "6% Plan" for financing the sale of automobiles. The advertisements stated that the rate of interest was only 6 percent on "your unpaid balance." In fact, however, the customer was charged 6 percent on the original amount of the account—the original unpaid balance—from the date of the obligation until the date that the account was closed. The Commission demonstrated that when interest is calculated in this manner, the effective rate is approximately 11½ percent. Cease-and-desist orders were accordingly issued. The companies carried the orders to Courts

[9] *FTC* v. *Pacific States Paper Trade Association*, 273 U.S. 53, 62 (1926).

[10] *General Motors Corp.* v. *FTC*, 114 F. (2d) 33 (1940), *Ford Motor Co.* v. *FTC*, 120 F. (2d) 175 (1941).

TABLE 23. Digest of Federal Trade Commission Cease-and-Desist Orders with Respect to Unfair Methods of Competition (Including Unfair and Deceptive Acts and Practices)[a]

- Acquiring confidential information unfairly
- Acquiring stock of competitor
- Advertising falsely or misleadingly
- Appropriating tradename or mark wrongfully
- Appropriating values created by a competitor's ingenuity, labor, or expense
- Bait advertising (an insincere offer to sell a product or service)
- Claiming indorsements or testimonials falsely
- Claiming trade-name rights wrongfully
- Coercing and intimidating
- Combinations of dealers to (1) prevent others from procuring goods or (2) influence the trade policy of competitors or suppliers
- Commercial bribery
- Conspiracies to fix prices, allocate markets, limit production, or refuse to sell
- Cutting off competitors' access to customers or market
- Cutting prices arbitrarily to discipline a competitor acting independently on price
- Dealing on exclusive and tying basis
- Deceptive pricing
- Delivering short measure
- Disparaging competitors and their products
- Enforcing payments wrongfully
- Enticing away competitors' employees
- Inducing breach of competitors' contracts
- Interfering with competitors or their goods
- Maintaining resale prices (except as legalized under state legislation and the Miller-Tydings Act)
- Misbranding or mislabeling
- Misrepresenting oneself and goods
- Offering deceptive inducements to purchase
- Operating secret subsidiary
- Passing off a product as and for that of a competitor
- Payola (payment of push money to induce favored treatment of one's product)
- Securing signatures wrongfully
- Selling below cost with intent to injure competition
- Simulating competitor or his product
- Spying on competitors
- Subsidizing business of one or more customers
- Threatening infringement suits, not in good faith, to stifle competition
- Using misleading names with respect to the identity of a seller or his goods
- Using or selling lottery devices—such as punchboards and pushcards—in merchandising a produce.

[a] *Digest of Decisions of the Federal Trade Commission* (Washington, 1940) and *Annual Reports of the Federal Trade Commission*. A weekly summary of Federal Trade Commission complaints, decisions, and orders may be secured by writing to the Publications Division, Federal Trade Commission, Washington, D C

of Appeal, claiming that they had always included in their statements the notation, "It is not 6% interest, but simply a convenient multiplier anyone can use and understand." The Courts of Appeal held, however, that the advertising was misleading on the ground that in a good many cases buyers would believe that they were paying 6 percent interest only on the current unpaid balance.

PREDATORY PRICE CUTTING UNFAIR UNDER SECTION 5

A prevalent fear of independents is that a dominant enterprise will use its financial power to cut prices below its actual accounting costs, with resulting

injury to independent sellers. Section 5 of the Federal Trade Commission Act has been applied to prohibit sales below cost *with the intent to injure competition.* In *E. B. Muller* v. *FTC*, two dominant and allied sellers of chicory decided to eliminate their only competitor, R. E. Schanzer, of New Orleans. Granulated chicory was deliberately sold at cost, or slightly below cost, for several years. The predatory intent of the dominant sellers was revealed in their business correspondence. One letter, for example, stated "I certainly hope that we can . . . eliminate him entirely, by making prices that he cannot meet without losing money."[11]

The Court of Appeals sustained the Commission's cease-and-desist order prohibiting the predatory price cutting. According to the court, "The fact that the sales were not greatly below cost does not aid the petitioners. It was not necessary that the evidence show that Schanzer [the independent] suffered loss. The purpose of the Federal Trade Commission Act is to prevent potential injury by stopping unfair methods of competition in their incipiency."

UNFAIR PRACTICES FROM THE STANDPOINT OF CONSUMERS

The essential purpose of the Wheeler-Lea amendment to the Federal Trade Commission Act is, we have seen, to safeguard consumers by (1) empowering the Commission to prohibit "unfair or deceptive acts or practices" (Section 5) and (2) formulating a definition of the term "false advertisement" applicable to the advertising of food, drugs, curative devices, and cosmetics (Section 15). Section 15 of the Federal Trade Commission Act, as amended, defines a false advertisement as follows:

> The term "false advertisement" means an advertisement, *other than labeling*, which is *misleading in a material respect;* and in determining whether any advertisement is misleading, there shall be taken into account (among other things) not only *representations made* or *suggested* by statement, word, design, device, sound, or any combination thereof, but also the extent to which the advertisement *fails to reveal facts material* in the light of such representations or material with respect to consequences which may result from the use of the commodity to which the advertisement relates under the conditions prescribed in said advertisement, or under such conditions as are customary or usual [italics supplied].

Whether or not an advertisement will be construed as being "false" or as making representations which are "deceptive" depends upon whether the advertisement is "misleading in a material respect." The word "material" means *not trivial*, and its application in any given case involves questions of degree and judgment. The fundamental questions to be considered in judging an advertisement are: (1) What are the representations? and (2) Are

[11] *E. B. Muller* v. *FTC,* 142 F. (2d) 511 (1944).

they true or not? False claims, misleading impressions, and false comparisons are all contrary to the Federal Trade Commission Act. The Commission is continually dealing with representations made by inference, innuendo, or suggestion. Advertising statements do not have to be categorical or unqualified to be condemned by the law.

Sections 12 to 15 of the FTC Act, as amended by the Wheeler-Lea Act, authorize the Commission to (1) prevent the dissemination of *false advertisements* for food, drugs, cosmetics, and therapeutic devices; (2) require advertisers to reveal that such products are dangerous or that their use may cause injury to bodily health when such is the case; and (3) bring suits to enjoin the use of false and misleading advertisements in the food, drug, cosmetic and device field when it is believed that such "would be to the interest of the public."

In the adjudication of Section 13, giving the Commission power to bring suits to enjoin alleged false advertisements, the courts have held that injunctions will be issued upon a showing of "potential pecuniary injury to the public."[12] This means that it is not necessary for the Commission to show that a product is intrinsically detrimental or that it is inherently dangerous. If the item is falsely advertised, and if it appears that the public is likely to spend money for it in a substantial way, an injunction may be granted.

REPRESENTATIVE CASES CONDEMNING FALSE AND DECEPTIVE ADVERTISING

The use of injunctive suits to restrain false advertisements, pending final disposition by administrative proceedings, saves the public many millions of dollars each year. In 1951, for example, the Commission secured an injunction against the advertising of Imdrin, a drug preparation composed principally of aspirin, thiamine chloride, calcium succinate, and caffeine. In nation-wide advertising, Imdrin was presented as an adequate, effective, and reliable treatment for arthritis, rheumatism, neuritis, sciatica, gout, neuralgia, fibrositis, and bursitis. The Commission alleged that the representations were false, and the Court of Appeals granted a restraining order. Subsequently, a cease-and-desist order was issued. With the issuance of the injunction against the advertisements, sales of Imdrin fell sharply. It is estimated that resulting savings to the public in a year amounted to several million dollars.

In most instances, the Commission handles cases of false advertising by regular administrative proceedings, without injunctive suits. An example of its day-to-day work is found in action to condemn the use of the word "free" to designate a product which in fact is not a gratuity. In the Book-of-the-Month-Club case (1953), the Commission was upheld by the Court of Appeals in its order against the use of the words "free" and "without cost" by a leading book seller. The Book-of-the-Month Club had typically adver-

[12] *FTC* v. *National Health Aids, Inc.*, 108 F. Supp. 340, 348 (1952).

tised "Free . . . to new members" a copy of a book to be sent to persons signing an attached coupon. The coupon constituted a contract and called for purchase of at least four books during the year. If a member failed to buy the four books, the Club demanded the retail price for the "free" book. The court held that the statement was false and deceptive, even though some people might not be misled by it.[13]

A further example of the Commission's action against "false advertisements" is found in the Max Factor case (1959). In its complaint, the Commission charged the Max Factor cosmetic firm with making false and misleading claims for its product "Natural Wave." This cosmetic, the company declared in advertisements and television broadcasts, was "A revolutionary answer to straight hair . . . because Max Factor has discovered . . . nature's own way to change the structure of your hair . . . from naturally straight to curly. . . . It penetrates through the hair, changing the *structure* of *each* individual hair . . . giving you a *natural* curl . . . you can now forget permanents *forever*" (see Figure 28).

The Commission declared that "in truth and in fact," Natural Wave "will not change the structure of the hair, nor will it change naturally straight hair to naturally curly hair." The hearing examiner issued an initial decision against the Max Factor company on January 12, 1959 (Docket 7280), and on February 26, 1959, the Commission itself affirmed the decision. By terms of the order, the company is ordered to cease and desist making claims, in any form of advertising, that its product will change the structure of hair or change hair from naturally straight to naturally curly.

During the course of a year, the Commission accepts stipulations and issues orders against a great variety of unfair and deceptive acts and practices. The matters include (1) medicinal remedies which promise relief for cancer, general debility, pyorrhea, arthritis, leprosy, pneumonia, heart disease, tuberculosis, asthma, and a host of other diseases; (2) cigarette advertising and its spurious claims; (3) correspondence schools and diploma mills; (4) encyclopedias and books; (5) orthopedic shoes; (6) inflammable sweaters; (7) sales of merchandise without disclosure of foreign origin or with false and misleading labels; and (8) the use of fictitious prices in the sale of merchandise.

COMMISSION HANDICAPPED BY INADEQUATE FUNDS

Each year the newspapers, magazines, radio, and television programs contain considerable amounts of advertising which is characterized by false claims, misleading impressions, and false comparisons. How is this to be explained? In large measure, the use and existence of such forms of advertising arise from the fact that the Commission does not have sufficient funds to enforce the law in a thoroughgoing and vigorous way. Applications for complaints received from businessmen and consumers total about 3000 per year.

[13] *Book-of-the-Month Club* v. *FTC*, 202 F. (2d) 486 (1953).

"A revolutionary answer to straight hair like this."

"Now you can give yourself . . . naturally curly hair."

FIGURE 28. A Representative Advertisement Declared "False and Misleading" by the Federal Trade Commission (Max Factor case, Docket 7280 [February 26, 1959]). The major part of the work of the FTC is concerned with false, misleading, and deceptive acts and practices. (Source: Federal Trade Commission)

The Commission, however, is able to initiate only a small fraction of the cases which should be prosecuted in the public interest.

Expenditures for advertising have increased enormously since 1914. It is estimated that some $225,000,000 were spent on advertising in 1914, and that today the sums spent are in excess of $11 billion each year. The number of persons working on deceptive practices, however, remains about the same as it was in 1914. Also, the staff has had to add to its work load the Wheeler-Lea Act (1938), the Wool Products Labeling Act (1939), the Fur Products Labeling Act (1951), the Flammable Fabrics Act (1953), and the Textile Fiber Products Identification Act of 1958.

The Commission recognizes that its staff cannot render adequate service in policing false and misleading advertising. As an alternative procedure, it has turned to members of the advertising industry themselves to enlist their cooperation and assistance in curbing abuses in advertising by means of voluntary action.

"PUFFING" STILL PERMITTED UNDER THE WHEELER-LEA AMENDMENT

The Wheeler-Lea amendment does not restrict the traditional practice of a seller to engage in "puffing" in the sale of his wares. The courts themselves, moreover, have accepted the use of such words as "perfect," "amazing," "prime," "wonderful," "extra fancy," and "excellent" as legitimate "puffing" in the sale of products, even though the evidence indicates that the words are not appropriate. In the Kidder Oil case (1941), for example, a company sold a lubricating oil containing graphite. The advertisements for the product claimed that it was a "perfect" lubricant which would actually enable one to operate a motorcar an "amazing distance" after the oil was finally used up. The Commission charged that the advertisements were extravagant, deceptive, misleading, and false, and issued a cease-and-desist order.

Upon appeal, the Court of Appeals set aside the significant part of the Commission's order on the ground that the extravagant language was only "innocent puffing." In the words of the Court, "What might be an 'amazing distance' to one person might cause no surprise to another. So far as we know, there is nothing 'perfect' in this world, but still it is a common term, which undoubtedly means nothing more than that the product is good or of high quality. We can conceive of situations where the use of such words might be deceptive and even fraudulent. As used by petitioner, however, we are of the opinion that they are nothing more than a form of 'puffing' not calculated to deceive."[14]

The action of the courts and Congress in accepting and permitting a large measure of exaggeration and flamboyant statements in present-day advertis-

[14] *Kidder Oil Co.* v. *FTC*, 117 F. (2d) 892, 901 (1941).

ing, it is generally recognized, costs consumers a substantial sum of money. Each year, for example, consumers are induced to spend an estimated $100,-000,000 for cold remedies, although competent medical opinion advises that rest and a liquid diet are in most cases the best means of treatment. The advertisements of the large tobacco companies, in particular, frequently seek to create impressions which cannot find support in competent medical opinion.

The great body of offensive, deceptive, and misleading advertising is generally agreed to have its basis in the profit-making activities of large-scale advertisers whose actions are dictated by a regard for their profit and loss statements. If their advertising agencies can show results in developing sales and profits, the advertisers typically approve the programs without regard to moral or ethical considerations. The agencies are thus "under the gun" to get results—to sell the goods which they are paid to promote.

MEASURES FOR STRENGTHENING THE EFFECTIVENESS OF THE FEDERAL TRADE COMMISSION

Persons who have followed closely the work of the FTC conclude that the Commission has barely scratched the surface of the problem of unfair competition and monopolistic pricing. At the same time they believe that the need today for public intervention to create and maintain competition is far greater than it was in 1914. Why has the Commission failed to operate more effectively? What can be done to strengthen its activities?

The Need for Greater Executive and Legislative Support for the Commission

In the past the President all too frequently has used appointments to the Commission for the purpose of rewarding faithful party members, without regard to their economic beliefs or training. Such appointments have been a principal cause for much of the ineffectiveness of the Commission's work. The Commission has also been continuously handicapped by inadequate appropriations. Individual cases are brought and won, but there is not sufficient money to go out into the field to investigate compliance or possible violations by other business firms.

Basically, the effectiveness of the Commission depends upon (1) the competence and "public mindedness" of the men appointed to serve as commissioners; (2) the ability, training, and experience of staff members appointed to investigate and prosecute cases; and (3) the amount of money which the Commission has to use in its work. If the public really desires an effective Commission, it will be necessary for the President to appoint able men who have an interest in maintaining effective competition and for Congress to give these men all needed financial support.

The Adoption of a Rule-Making Power

A weakness of the Federal Trade Commission Act, as interpreted by the Commission, is the absence of power to make imperative rules. Section 6 (g) of the Act provides that the Commission may make "rules and regulations for the purpose of carrying out the provisions of the Act." The Commission, however, has construed this provision narrowly to mean rules for the internal administration of the Commission. At no time has it claimed or used the power to make imperative rules for business conduct.

A "rule" is a prescribed guide for conduct or action. It is a specific guide—one which leaves little or no room for interpretation. Thus, a rule might provide that "it shall be illegal to sell or offer to sell products at prices which are purported to be reduced from what are in fact fictitious prices." With a criterion of unfair competition established, the Commission would have only to get the facts to determine lawful or unlawful behavior. Businessmen would also know the exact limits beyond which they should not go. The establishment of imperative rules, moreover, would permit the Commission to apply the law to an entire industry group—"Here is the rule; everyone must comply."

In the absence of rule-making power, the Commission must proceed on a case-by-case basis. This means that it must (1) get the facts and (2) apply them to the general policy of the law, subject to review by a Court of Appeals and the Supreme Court. No one knows how the changing and varied personnel on the Commission and the courts will interpret and apply the general provisions of the law in disposing of cases until a case is brought and decided. After a case has been decided, moreover, the rule of law in the decision is usually construed as applying only to the particular set of facts. It is a rule worked out to solve a case at hand. Anyone attempting to express an opinion on what the court meant by anything it has said is likely to find himself in an argument. This is true, moreover, whether the problem discussed is one of basing-point pricing, misrepresentation, or criminal law. With a rule-making power, business regulation can be made more specific, more consistent, more stable, and more universal in its application.

The formulation and use of "trade practice" rules indicates that industry, as well as the Commission, finds it useful to have specific "guide posts" and "warning flags." Trade practice rules, however, are *advisory* rules, not imperative rules, and business firms are free to observe them or not as they desire. Each violation must be prosecuted as a violation of the Federal Trade Commission Act and not as a violation of a rule.

An Expeditious and Timely Settlement of Cases

A major criticism of the Federal Trade Commission's activities is the time-consuming nature of its operations. The significance of delay arises in the facts that (1) business practices, such as local price cutting, change with

changes in competitive conditions; and (2) delay in prosecution frequently gives a business concern adequate time to enjoy the full advantage of an illegal act. An independent producer, moreover, is likely to get discouraged in waiting for public relief and yield to the will of the dominant firms.

Investigation shows that it has taken the Commission ten years or more to issue a cease-and-desist order or a dismissal in certain important antimonopoly and false and misleading advertising cases.[15] In 1959 the House Committee on Small Business reported that eight cases involving charges of discrimination and unfair practices by the largest processors and distributors of dairy products had been pending for more than four years. If a person files charges with the Commission, he may not, upon the basis of past experience, secure relief for several years. Even then the complainant faces the prospect of further delay because of appeals to, and prolonged litigation in, the federal courts.

There are a number of factors which account for the delay in processing cases through the Commission. Trial attorneys frequently complain about the inadequacy of initial investigations and the need to make supplementary investigations. In a great many cases, moreover, the Commission has been unwilling to permit its attorneys to use the power of subpoena in securing evidence. During the course of a trial much time is lost because of the Commission's policy to be bound by judicial technicalities and rules of procedure.

A principal factor making for delay has been the weak and vacillating attitudes of the Commissioners themselves toward the issues in dispute. After investigational work has been completed, it frequently has taken the Commission six months to a year to decide whether or not a formal complaint should be issued. In some cases, the Commission has taken from three to nine years to decide whether to issue a complaint or close the case. If and when an "initial decision" has been appealed to the Commission, the Commission has taken from one to three years or even longer to decide upon the appropriate disposition of the case.

The vacillating attitude of the Commission in deciding what to do about a case reflects, in part, the fact that respondents, their counsel, and other persons having an interest in a case commonly meet with Commissioners and staff members participating in the deciding function to discuss cases which are in process of being decided. The Administrative Procedure Act prevents a government attorney handling one of the Commission's cases of adjudication (a case to be heard or tried) from discussing it with any one of the Commissioners, the trial examiner, or others employed by the Commission who have the responsibility for making the decision. At the same time, however, the Act does not condemn, or provide penalties for, action by respondents and their counsel in approaching Commissioners and such staff members charged with the responsibility of deciding a case. All too often,

[15] *Final Report of the Select Committee on Small Business*, 82nd Congress, second session, House Report 2513, 1952.

it appears, Commissioners are induced to believe that various cases can be settled or dismissed by the elapse of time or by the acceptance of trade practice conference rules.

The Administrative Procedure Act protects a respondent from having his case of adjudication discussed *ex parte* (without his being present). It does not, however, protect the public from *ex parte* discussions and considerations initiated by the private interests directly concerned. This criticism of the harm to the public flowing from delays in handling cases because of private conferences with Commissioners is not peculiar to the Federal Trade Commission. It applies with equal force to all administrative agencies subject to the Administrative Procedure Act.

A further reason for delay is the practice of the Commission to treat complaints as "cases at law." This means that trials are set, to be conducted according to court rules, with legal rules of evidence. The whole idea of an administrative agency was—and still is—to expedite cases by administrative action. An administrative commission has its own staff to investigate complaints and to advise the agency. The commission also can make its own rules of procedure and decide upon the evidence to be considered. Its task is to apply general statutes enacted by Congress. If it should act in an arbitrary or unfair manner, the law always provides for a *subsequent* appeal to the courts. As an administrative agency of experts in the field of business regulation, the commission should act expeditiously as an umpire, not as a court at law.

The Provision of Penalties for Monopolistic Price Fixing and Unfair Competitive Practices

It is important to remember that the Commission is powerless to punish individuals and corporations who are found to be guilty of monopolistic practices and destructive methods of competition. Only when a respondent violates a cease-and-desist order can he be assessed a penalty. A cease-and-desist order merely directs a defendant not to repeat his offense in the future. If he complies, there is no penalty.

At the present time, the Commission finds itself concerned with monopolistic practices which have been long established. The basing-point formulas, which were condemned by court decisions during 1945–1948, for example, had been in use for periods up to fifty years. The final adjudication of a case may require five or ten years, and during this period the public and competitors may suffer considerable damage. In all such cases, the penalty of a cease-and-desist order is too mild. If monopoly is to be effectively deterred, the law should provide for the levying of penalties against proven monopolistic action. The Commission itself, moreover, should be empowered to request an injunction against monopolistic and unfair practices, whenever it appears that substantial (not trivial) damage *may* result to the public or to competitors. If the Commission's injunctive power as applied to food, drugs,

and cosmetics, were so extended, it would greatly deter many business firms from engaging in such activity.

14

The Clayton and Robinson-Patman Acts

During the debates on the Clayton Act, Senator Walsh of Montana declared: "The purpose of the legislation of which the pending bill forms a part is to preserve competition where it exists, to restore it where it is destroyed, and to permit it to spring up in new fields."[1] With this chief purpose in mind, Congress enacted the Clayton Act, which was signed by President Woodrow Wilson on October 15, 1914.

The heart of the Clayton Act is Section 2, which prohibits price discrimination in the sale of "commodities of like grade and quality" when the effect is to injure or prevent competition. Price discrimination is identified by considering variations in the prices currently received by a seller at his mill (after deducting freight allowed or defrayed by the seller), in the sale of the same class of goods to various buyers in the same trade classification under substantially similar conditions.

Additional measures place prohibitions, under specified conditions, on (1) the use of exclusive sales or tying contracts, (2) the corporate ownership of stock in competing corporations, and (3) interlocking directorates in large banks and competing corporations.

Following the passage of the Clayton Act, it was found that certain sellers frequently sold identical products to very large buyers at lower prices and to small buyers at higher prices, under the guise of quantity discounts. In order to strengthen the prohibition on this type of discrimination, Congress passed the Robinson-Patman Act (1936), as an amendment to Section 2 of the Clayton Act.

The Clayton Act, as amended, also provides that "any person" injured by practices condemned in the legislation may sue in any district court and recover threefold the damages sustained, including costs of the suit. The Federal Trade Commission Act, in contrast, does not provide right of private suit for treble damages.

[1] *Congressional Record,* October 5, 1914, Vol. 51, p. 16145.

BACKGROUND FOR THE CONDEMNATION OF PRICE DISCRIMINATION

Section 2 of the original Clayton Act was designed primarily to prevent injurious discriminations, especially those arising in the exercise of geographic discrimination against a rival seller. In the words of the House committee which reported the bill, "Section 2 of the bill is intended to prevent unfair discriminations. It is expressly designed with the view of correcting and forbidding a common and widespread unfair trade practice whereby certain great corporations . . . seek to secure a monopoly . . . selling their goods, wares, and merchandise at a less price in the particular communities where their rivals are engaged in business than at other places throughout the country."[2]

The Robinson-Patman amendment, enacted in 1936, sought to (1) strengthen the prohibition against price discrimination and (2) make it applicable to discriminations practiced by a supplier between or among customers competitively engaged in the same area (personal discrimination).

The main problem of personal discrimination, it was found, is that of large-scale buyers receiving, and a seller conceding to such buyers, price concessions which cannot be justified on the basis of cost savings. A large amount of evidence had shown that many of the "economies" and much of the "efficiency" of financially large corporations arose in their superior bargaining power—in their ability "to throw their weight around" in determining buying prices, as well as selling prices. Such economies, Congress believed, did not, and do not, reflect genuine producing and selling efficiencies. Senator Robinson declared in the Senate shortly before the final passage of the bill: "The sole purpose of the proposed legislation is to prevent unfair discriminations by a seller in favor of certain purchasers who have enormous purchasing power."[3]

Price discrimination in favor of large buyers takes several forms. The quoted price is the starting point from which a seller makes concessions for special deals, discounts for volume purchases, cash discounts, allowances for advertising and promotional services, and variations in guarantees and replacement arrangements. Such concessions, variations, and allowances may be justified on the basis of cost savings. However, they may also serve as a cloak for substantial reductions in the price of the product itself. Large buyers are frequently able to secure products of like grade and quality at prices substantially less than those paid by small buyers, after making due allowance for the cost reductions of large-scale purchases.

The price discriminations enjoyed by large buyers, and against which the

[2] *Antitrust Legislation*, Committee on the Judiciary, 63rd Congress, second session, House Report 627, May 6, 1914, pp. 8–9.

[3] *Congressional Record*, June 1, 1936, Vol. 80, p. 8419.

Robinson-Patman amendment was designed, are generally accomplished by four methods:

1. The making of discounts for volume purchases which cannot be justified by the lower cost of selling and delivering the large quantities.
2. The purchase of products such as canned foods and tires under private labels at prices which are substantially lower than those at which similar products of like grade and quality are sold to competing buyers under seller's labels.
3. The granting of advertising and promotional allowances on purchases made by large-scale buyers which are not granted on proportionally equal terms to other competing buyers.
4. The purchase by a large buyer, having outlets over wide areas or nation-wide, at a *national price* as of the headquarters of the buyer, for delivery at that price to local affiliates throughout the country. It is alleged that small-volume purchasers at the local level frequently cannot buy at the favorable national price and that the "national buy" cannot be justified by cost savings.

PRICE DISCRIMINATION MADE *PRIMA FACIE* ILLEGAL WITH BURDEN OF PROOF RESTING ON SELLER TO PROVE THAT IT IS NOT SO

The main provision of the Clayton Act, as amended by the Robinson-Patman Act, is as follows:

> Sec. 2. (a) That it shall be unlawful for any person engaged in commerce . . . to discriminate in price between different purchasers of commodities of like grade and quality . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered . . .
>
> (b) Upon proof being made . . . that there has been discrimination in price or services or facilities furnished, the burden of rebutting the *prima facie* case, thus made by showing justification shall be upon the person charged with a violation of this section, and unless justification shall be affirmatively shown, the Commission is authorized to issue an order terminating the discrimination . . .

The basic idea of discrimination is that of charging some person or persons a higher price than that charged others for the same class of commodi-

ties without a good and valid reason. Price differences on account of grade, quality, quantity, cost of selling, or cost of shipping are specified in Section 2 as being valid reasons for price differences. By the terms of the act, price discrimination is not illegal per se, but rather "where the effect . . . may be substantially to lessen competition." The phrase "where the effect . . . may be" has been interpreted by the Court to mean where a future effect (injury to competition) is reasonably probable, rather than certain or remotely possible. It appears that the term "substantially" was inserted to indicate that the law is not concerned with trifles.

When a discriminator cuts prices to the injury of a competitor engaged in the same line of business, it is the lower price which is considered to be illegal, if the result is substantially to lessen competition. Discrimination may also be practiced by a seller for the purpose of getting a difference in prices as between his customers. In this case, attention is shifted to the higher price. If one customer has a higher cost-price than another, without a valid reason, the effect may be substantially to lessen his ability to compete. Discrimination always involves a higher price and a lower price, and the rule against discrimination in Section 2 has been held by the courts to be applicable to discriminatory higher prices as well as to discriminatory lower prices.[1]

The term "price" is not defined in the Clayton Act, as amended. Economists have typically qualified the word price in some way. That is, they have used the word with an adjective, such as "market price," "f.o.b. mill price," or "delivered price." Some adjective, it appears, is necessary if we are to be precise. Historically, "market prices," as developed in central markets, have usually been taken as the kind of prices which public policy should seek to promote. Market price, in this sense, is the price of the commodity, as such, at the point of centralization. It does not include the cost of shipping the products from the central market to scattered destination points. Market price, so considered, is an f.o.b. shipping-point price.

EXEMPTION OF DISCRIMINATION PRACTICED TO MEET COMPETITION

In attempting to get at the problem of cutthroat competition, proposals were made to prohibit geographic discrimination outright, in all of its various forms. The Senate committee, however, insisted upon a proviso to permit discrimination "in good faith to meet competition" on the ground that some discrimination enables a manufacturer to reach out into other sales areas and compete with distant sellers. As a compromise measure, Congress therefore accepted the idea of permitting discrimination practiced "to meet competition."

[1] *George Van Camp and Sons* v. *American Can Co.*, 278 U.S. 245, 254 (1929); and *American Can Co.* v. *Ladoga Canning Co.*, 44 F. (2d) 763 (1930).

The difficulty of trying to draw a line between (1) discriminatory price cutting to injure competition and (2) discriminatory price cutting "to meet competition" was recognized by several members of Congress, but the problem was not resolved. Senator Cummins, for example, declared: "Made in good faith to meet competition–imagine the government endeavoring to prove that a particular instance of price cutting was not made in good faith to meet competition!"[5]

The fact is that discrimination is usually practiced "to meet competition"–either by matching a competitor's price or by undercutting it–for a seller would not cut his price to some *customers* unless there was a competitive reason to do so. Businessmen do not practice discrimination merely for the sake of discriminating. Under Section 2 of the original Clayton Act the "meeting competition" proviso came to be regarded as a complete defense to the charge of illegal price discrimination.[6] Thus the prohibition on price discrimination in Section 2 was virtually nullified by the proviso permitting discrimination "made in good faith to meet competition."

In debates on the Robinson-Patman legislation, many congressmen expressed the view that the exemption of discrimination to meet competition should be eliminated entirely on the ground that the proviso had seriously weakened the main prohibition. Such action was not taken. The sponsors of the Robinson-Patman bill, however, indicated that the reply of "meeting competition"–which was retained in the legislation–was not to be a complete defense. According to Congressman Utterback, "It is to be noted . . . that this does not set up the meeting of competition as an absolute bar to a charge of discrimination under the bill. It merely permits it to be shown in evidence. This provision is entirely procedural."[7] The view of the sponsors was that if discrimination worked injury, it should be condemned, regardless of the "meeting competition" defense.

Section 2 (b) of the Clayton Act permitting discrimination "to meet competition" was amended by the Robinson-Patman Act as follows: "*Provided, however*, That nothing herein contained shall prevent a seller rebutting the *prima facie* case thus made by showing that his lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor" (italics supplied).

This proviso means that a discriminating seller may show that he cut the price on *some* sales *to meet* the price of another seller, but that he is not permitted to show that he undercut that price. Discrimination to undercut is forbidden.[8]

[5] *Congressional Record*, August 25, 1914, Vol. 51, p. 14228.

[6] See, for example, *FTC* v. *Staley Mfg. Co.*, 324 U.S. 746, 752–753 (1945).

[7] *Congressional Record*, Vol. 80, June 15, 1936, p. 9418.

[8] *Prohibition of Price Discriminations*, Committee on the Judiciary, 74th Congress, second session, House Report 2287, March 31, 1936, p. 16.

MORTON SALT CASE—AN INTERPRETATION OF THE QUANTITY DISCOUNT RULE

Section 2 (a) of the Robinson-Patman Act, we have seen, makes it unlawful to discriminate in price, but permits a respondent to show that his price differences, based upon differences in quantities sold, make only due allowance for differences in cost of manufacture, sale, or delivery. The leading court case which has been decided on discrimination based upon quantity buying is the Morton Salt case (1948).

The Morton Salt case considers (1) the application of Section 2 to quantity discounts and (2) the question of whether the defendant has the burden of showing that his quantity discounts are justified by cost savings.

The Commission argued that price differentials to large purchasers should be no greater than are justified by cost savings. Beyond this point, they would be discriminatory. It contended that (1) Morton's quantity discounts were discriminations, (2) the effect of the price differences *may be* to injure competition; (3) respondent did not show that its price differences were justified by cost savings, and (4) respondent did not show that the lower prices were made in good faith to meet competition.

The company contended that (1) its quantity discounts, openly available to all, were not discriminatory under the Act; and (2) the Commission had the burden of proving an absence of cost justification for the price differences. The company's price schedule, with freight paid to destinations, was as follows:

	Per case
Less-than-carload purchases	$1.60
Carload purchases (approx. 1035 cases)	1.50
5000-case purchases in any consecutive 12 months	1.40
50,000-case purchases in any consecutive 12 months	1.35

The Supreme Court held for the Commission. To the argument that the discounts were not discriminatory because they were openly available to all, the Court replied that, in fact, only four or five large buyers were in a position to utilize the largest discount. The purpose of the Robinson-Patman Act, it declared, was "to deprive a large buyer" of any competitive advantage it might secure in lower cost prices, except where the lower prices can be justified by a savings in cost or by a seller's effort to meet a competitor's price. The Court also stated that the burden of justifying the lower sale price rests with the defendant.[9]

Upon the basis of the Morton Salt case, the rule appears to be firmly established that henceforth a seller, charged with illegal discrimination, must be prepared to justify his quantity discounts by showing actual cost savings.

[9] *FTC* v. *Morton Salt Co.*, 334 U.S. 37, 42-43 (1948). As a result of the decision of the Supreme Court in 1948, all quantity discounts were withdrawn by the Morton Salt Company, and no discounts for quantity buying have since been applicable.

JUDICIAL INTERPRETATION OF THE PROVISO "MEETING COMPETITION"

The issue of whether "meeting a competitor's price" is a complete defense to the charge of price discrimination or only a "procedural aid" was presented to the courts in the Standard Oil of Indiana case (1949). The Federal Trade Commission charged the Standard Oil Company with illegal discrimination in selling gasoline in Detroit to four large gasoline dealers (each making substantial retail sales) at a price 1½ cents under the price charged some 358 other gasoline dealers who competed with the 4 favored dealers in the same area. The Commission alleged that this discrimination resulted in injury to competition between the favored and the nonfavored dealers in the direct sale of gasoline to the public.

Standard offered certain cost data to establish the lower cost of selling to quantity buyers, but the Commission found that the data did not bear upon conditions in the Detroit area. Thereupon, Standard declared that it was simply meeting the lower price quoted by competitors, and that "meeting competition" is a complete and valid defense. Standard's competitors consisted of several small local refiners selling off-brand gasoline. Their prices were nondiscriminatory and were made lower in order to find a selling outlet. The Commission refused to accept this defense and maintained that price discrimination *which injures competition is illegal.*

The Court of Appeals in 1949 upheld the Commission's view that "meeting competition" is not a valid justification for discrimination if injury has, in fact, resulted. The Court reasoned that Congress, in amending the Clayton Act in 1936, sharply restricted the right to discriminate. In the Robinson-Patman amendment, said the Court, the good-faith proviso is not a complete defense but only a "procedural aid." This means that when the Commission alleges illegal discrimination, the accused can answer that it was done in good faith. However, if the Commission shows that injury to competition not only was probable but actually occurred, the good-faith proviso ceases to be a defense.[10] The Standard Oil Company promptly appealed this decision to the Supreme Court.

It is significant to note that during the period in which the Standard Oil of Indiana case was pending, there occurred a change in the attitude of the Commission on price discrimination. The point of view developed that discrimination *should be* permitted, particularly in industries in which economic power has become concentrated in the hands of a few sellers (oligopoly). In such industries, it was reasoned, price competition among large sellers is often weakened or nonexistent. In so far as it operates, it takes the form of discriminatory price concessions to *some* buyers. If the Robinson-Patman Act is applied, it may stifle this *limited* competition. By permitting some discrimination, however, it is possible for some degree of price compe-

[10] *Standard Oil Co.* v. *FTC*, 173 F. (2d) 210 (1949).

tition to develop among oligopolistic sellers. Upon the basis of this line of reasoning, the Commission publicly announced in June 1949, that ". . . all of the Commissioners believe that *on balance* it would be preferable to make the good faith meeting of competition a complete defense."[11] Beyond doubt, the new attitude of the Commission that discrimination to meet competition should be a complete defense considerably weakened the position of the government attorneys in appealing the Standard case to the Supreme Court.

In a five-to-three decision, the Supreme Court reversed the Standard Oil of Indiana decision and ruled that even though competition is injured, a seller may justify price discrimination by showing that the lower price was made in good faith to meet the lower price of a competitor.[12] The majority conceded that Congress had made certain changes in the original Clayton Act to restrict the practice of discrimination. However, none of the changes in the amendment, it was stated, changed the "actual core of the defense." In the view of the majority, "wherever a lawful lower price of a competitor threatens to deprive a seller of a customer, the seller, to retain that customer, may in good faith meet that lower price" [by discrimination].

The majority, no doubt, believed that its decision preserved the right of a seller "to compete." This, however, is only one side of the coin. On the other side is the fact that the use of price discrimination by a dominant supplier is a club which serves to discourage price competition by small, local competitors. If a local competitor knows that his price is going to be matched by the use of price discrimination, he will be reluctant to quote a lower price to buyers. The lower price of the local, independent supplier applies *to all* of his sales, and the independent is in no position to offset his low prices by sales to other customers at higher prices.

Justice Reed, in the minority opinion on the Standard case, spoke sharply against the "erroneous" conclusion that "meeting competition" is a complete defense. In his view, Congress in 1936 clearly intended to narrow the avenue of escape for price discriminators. The decision of the majority, he declared, means that "no real change has been brought about by the amendment," and leaves "what the seller can do almost as wide open as before." In effect, he concluded, the law on discrimination has been taken back in substance to the law of 1914 which permitted discrimination made in good faith to meet competition.

RESULTS OF THE STANDARD OIL OF INDIANA DECISION

According to the House Committee on Small Business, the Standard Oil decision (1951) "has operated to limit and impair seriously the authority and power of the FTC to deal with destructive price discriminations." In

[11] Hearings Before Subcommittee No. 1 of the House Committee on the Judiciary on S. 1008, 81st Congress, first session, June 8 and 14, 1949, p. 61. Italics supplied.

[12] *Standard Oil Co.* v. *FTC*, 340 U.S. 231 (1951).

substance, the Committee declares, the Supreme Court "held that a giant concern, such as Standard Oil Company of Indiana, is privileged to discriminate in price with the effect of destroying its competitors, destroying its customers, substantially lessening competition, and tending to create a monopoly, so long as that giant concern shows that it has accomplished all of those things in 'good faith' in meeting an equally low price of a competitor."[13]

As a result of the decision of 1951, the Committee states: "Price discrimination practices are being used in a number of industries with deadly effect on small business firms." These include the dairy industry, bread baking, and gasoline.

In an effort to set aside the Standard Oil decision of 1951, several proposals have been made in Congress to restrain price discriminations which injure competition. Their essential purpose is to require each supplier to accord equal treatment to all of his customers who are in competition with each other (thus restraining injurious discriminations among *persons*). Their purpose is also to require each supplier to accord equal treatment to customers in different localities (taking into account differences in delivery costs), in order to prevent injury to local suppliers in direct competition (thus restraining injurious *geographic* discrimination). Opposition of large business firms to legislation restraining injurious price discriminatons, however, has effectively prevented its enactment, and favorable consideration by Congress is not bright.

THE "QUANTITY LIMIT PROVISO" OF THE ROBINSON-PATMAN AMENDMENT

One of the proposed drafts of the new legislation on quantity discounts prohibited the granting of discounts on quantities purchased in excess of a car lot. The idea was that there should be some limit beyond which quantity differentials should not be permitted. This principle, it was observed, has long been followed by the Interstate Commerce Commission in regulating railroad rates, and it was believed that it would be sound public policy to make a similar requirement for industrial prices.[14] The proposal brought forth considerable opposition from organized industry groups, and a modified version of the carlot quantity limit proviso was drafted.

The new draft, which was subsequently adopted by Congress and made a part of Section 2 (a) of the Clayton Act, reads as follows: "*Provided, however,* that the Federal Trade Commission may, after due investigation and hearing to all interested parties, fix and establish quantity limits, and

[13] *Final Report,* Select Committee on Small Business, 85th Congress, second session, House Report 2718, January 3, 1959, pp. 87-92.

[14] *To Amend the Clayton Act*, Hearing Before the Committee on the Judiciary, House of Representatives, 74th Congress, first session, 1935, pp. 27, 222.

revise the same as it finds necessary, as to particular commodities or classes of commodities, *where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or promotive of monopoly in any line of commerce*" (italics supplied). Thus it is that the Federal Trade Commission now has the authority to fix and establish *quantity limits* under the conditions so prescribed.

In commenting on the addition of the revised quantity limit proviso to section 2 (a) of the Clayton Act, the Senate Committee on the Judiciary stated:

> This proviso is added by recommendation of your committee. It is designed to enable, when necessary, the determination of quantity limits as to various commodities, beyond which quantity price differentials shall not be permitted even though supported by differences in cost.
>
> It rests upon the principle that where even an admitted economy is of a character that is possible only to a very few units of over-shadowing size in a particular trade or industry, it may become in their hands nonetheless the food upon which monopoly feeds, a proboscis through which it saps the lifeblood of its competitors; and that in forbidding its use and foregoing its benefits the public is but paying a willing price for its freedom from monopoly control. A similar limitation has been applied without challenge for nearly half a century in the field of transportation, in refusing to extend freight rate differentials beyond the carlot quantity.[15]

APPLICATION OF THE QUANTITY LIMIT PROVISO

The Commission has had numerous requests to establish quantity limits for various products. As an initial effort, the Commission adopted a resolution on July 7, 1947, calling for an investigation of the rubber tire industry in order to secure information for use in determining whether or not it should fix quantity limits in that industry. This resolution was adopted, it was said, because of the vast number of complaints received from independent tire dealers, who claimed that the policy of the manufacturers to charge independent dealers substantially higher prices than those charged large buyers was driving the independents out of business. The "large buyers" were the mail-order concerns and oil companies who bought "private brand" tires which were of "like grade and quality" as those sold to independents.

The Commission issued a quantity limit rule for replacement tires and tubes on January 4, 1952. Briefly stated, the rule provided that a quantity of 20,000 pounds, approximately one carload, ordered at one time for delivery at one time, is the maximum quantity which may be used to justify price differentials based upon quantity. This meant that a tire distributor who ordered several carloads had to pay the same price per carload as a dis-

[15] *To Amend the Clayton Act,* Committee on the Judiciary, 74th Congress, second session, Senate Report 1502, January 16, 1936, p. 6.

tributor who ordered one carload at a time. The rule did not apply to tires sold to automobile manufacturers for use on new cars.

The Commission found that the largest buyers of replacement tires paid from 26 to 30.5 percent less for passenger tires and from 32 to 40 percent less for truck tires than the prices paid by the smaller buyers. Large volume discounts enabled the "mass merchandisers" to sell tires and tubes at retail prices about equal to the cost of the smallest distributors.

The action of the Commission in fixing a quantity limit rule for replacement tires and tubes brought forth strong protests from the large tire manufacturers and mass distributors. Court action contesting the validity of the rule was immediately initiated by industry members. The Court of Appeals in 1957 set aside the Commission's order on the very narrow grounds of procedure, and the case was not appealed to the Supreme Court.[16] The work of the Commission for ten years in handling and litigating the case thus failed to provide relief to small business injured by practices which gave rise to the proceedings. At the present time, the Commission shows no interest in further enforcement of the quantity limit proviso.

SECTION 2 AND THE RIGHT TO SELECT ONE'S OWN CUSTOMERS

The final proviso in Section 2 provides that "*nothing herein contained shall prevent persons* engaged in selling goods, wares, or merchandise in commerce *from selecting their own customers in bona fide transactions* and not in restraint of trade" (italics supplied). The intent of Congress in adopting the Federal Trade Commission and Clayton Acts was to declare illegal all business practices which are likely to promote monopoly. In considering various types of unfair conduct, much attention was given to the practice of large mergers, controlling the output of basic commodities, particularly of iron and steel, coal, and the nonferrous metals, to refuse to sell to dealers and small fabricators who were dependent upon the mergers for supplies.

A provision was accordingly included in the first draft of the Clayton Act making it "unlawful for the owner or operator of any mine or for any person controlling the product of any mine engaged in selling its product in commerce to refuse arbitrarily to sell such product to a responsible person, firm, or corporation, who applies to purchase such product."[17] This provision, in particular, the House report indicated, was designed to eradicate the most extreme form of discrimination found in the practice of the large mergers in coal, iron, copper, and other minerals to refuse to sell to dealers and small manufacturers.

In the final enactment of the Clayton Act, the original section was en-

[16] *FTC* v. *B. F. Goodrich Company et al.*, 242 F. (2d) 31 (1957).

[17] *Antitrust Legislation*, Committee on the Judiciary, 63rd Congress, second session, House Report 627, May 6, 1914, p. 10.

tirely eliminated, and in its place there was adopted the proviso legalizing the right of "persons" to select their own customers when "not in restraint of trade."

In explaining Section 2 on selection of customers, the Senate Committee on the Judiciary stated: "The limitation is made by amendment that the selection must be in *bona fide* transactions and not in restraint of trade, which will enforce good faith and prevent restraint of trade by this method."[18]

The clear import of Section 2 is that the seller's basic right to select customers in trading loses its validity when it means discrimination and a lessening of competition between the favored buyer and the person denied supplies. The Federal Trade Commission, however, so far has not used Section 2 in condemning refusal to sell which lessens competition and restrains the trade of buyers denied supplies.

In general, it appears that the Federal Trade Commission stands ready to prosecute refusals to sell only when they are based upon illegal exclusive dealing arrangements or upon collusive restraint. This pattern of attack follows closely that employed by the Antitrust Division, Department of Justice.

Since the main purpose of the Federal Trade Commission is to prosecute restraints which "lessen competition"—*without regard to restraint of trade, attempts to monopolize, or conspiracy*—it would appear that the Commission, in particular, should take steps to broaden its attack on the problem of refusal to sell. Its appraisal and prohibitions (cease-and-desist orders) should reach out and condemn impediments which are short of Sherman and Clayton Act violations (see also Chapter 9, pages 194–198).

TYING RESTRICTIONS UNDER THE CLAYTON ACT

Tying contracts and exclusive dealing arrangements have long been condemned by economists as unfair methods of competition. The courts, however, have proceeded slowly in outlawing such contracts. The sale or lease of patented products with tying restrictions, in particular, was accepted by the Supreme Court as a valid form of contract. Thus, in the Mimeograph case (1912), the Court upheld the right of the A. B. Dick Company to sell its mimeograph machines on condition that they be used only with stencils, paper, ink, and other supplies made by the A. B. Dick Company. In the view of a majority of the Court, such a restriction was valid on the ground that a patent owner can use or suppress a patent as his interests may dictate.[19]

The decision of the Supreme Court in the Mimeograph case, as well as the growing use of tying arrangements to exclude competitors from the field, led Congress specifically to include in the Clayton Act a provision forbidding

[18] Committee on the Judiciary, 63rd Congress, second session, Senate Report 698, July 22, 1914, p. 6.

[19] *Henry* v. *A. B. Dick Co.*, 224 U.S. 1 (1912).

the use of tying restrictions *which substantially lessen competition.* Section 3, in substance, condemns the following arrangements whenever there is substantial injury to competition:

1. "Tie-in" sales: the sale of a machine on condition that the buyer will also buy materials to be used with the machine.
2. Exclusive dealerships: the sale of goods on condition that the customer (dealer) will not buy the goods of a competitor.
3. "Full-line forcing": the sale of one line of goods on condition that the customer (dealer) will also buy the other lines produced by the seller.
4. Requirements contracts: the sale of a product on condition that a customer will buy his subsequent needs of that product from the seller.

The Standard Oil of California decision (1948) on exclusive dealing arrangements brought life and vitality to Section 3. The Standard Oil Company was the largest seller of gasoline in the "western area," Arizona, California, Idaho, Nevada, Oregon, Utah, and Washington. Dealers under contract with the company were required to purchase and sell only those petroleum products, tires, tubes, batteries, and accessories handled by the company. The District Court found that competition was substantially lessened by these contracts. In reaching this decision, Judge Yankwich reasoned that there was *a substantial lessening of competition* because the contracts covered "a substantial number of outlets and a substantial amount of products." The relevant factor in determining legality or illegality, he declared, *is whether or not a substantial amount of trade is covered by the contracts.* If it is, the exclusive dealing contracts are illegal. Questions of injury to competitors, size of seller, reasonableness of the restraint, protection of good will, and benefits to the customers, the court concluded, are not standards to be considered in applying Section 3.[20]

The Standard Oil Company appealed the ruling of the District Court to the Supreme Court. In a five-to-four decision, the Supreme Court upheld the principle that the validity of contracts under Section 3 is to be tested by whether a "substantial portion of commerce is affected"—rather than by an actual demonstration that competitive activity is diminished.[21]

The Standard Oil of California decision is a landmark in the field of tying arrangements in that it establishes a single criterion for testing the legality or illegality of such contracts, namely, whether or not a substantial amount of the trade in a sales area is covered by such contracts ("the substantiality test"). This test, it may be noted, stands between the per se test (which would condemn all tying arrangements without qualification) and the rule-of-reason test (which would permit contracts tying up a substantial share of

[20] *U.S.* v. *Standard Oil Co. of California*, 78 F. Supp. 850, 857 (1948).

[21] *Standard Oil of California* v. *U.S.*, 337 U.S. 293 (1949). In subsequent cases the Court has indicated that it regards the Standard decision as a sound interpretation. See *Richfield Oil Corp.* v. *U.S.*, 343 U.S. 922 (1952).

the market provided that *some* "free" dealers [some alternatives] still remain).[22]

SECTION 7 AND MERGERS

In Chapter 9, we discussed the adoption of Section 7 of the Clayton Act, condemning monopolistic mergers based upon the acquisition of stock; and also the enactment in 1950 of an amendment to Section 7, condemning the acquisition of stock *or* assets, where the effect may be substantially to lessen competition.

The Commission initiated its first formal proceeding under the new Anti-merger Act on June 16, 1952. A complaint (Docket 6000) was issued against the Pillsbury Mills, Inc., the second largest flour milling company in the nation. The complaint charged that Pillsbury acquired the assets of two important competitors in the southeast area of the United States—the "hot biscuit" territory. The two competitors were Ballard and Ballard, producers of flour, flour base mixes, and animal feeds; and the Duff Baking Mix Division of American Home Foods, Inc., a producer of flour base mixes. As a result of these acquisitions, it was charged, Pillsbury gained a position in the southeastern area as the second largest seller of family flour, became the largest seller of bakery flour and mixes, and secured an almost complete monopoly on flour mixes.

In the Pillsbury complaint the Commission charged that both Pillsbury and the acquired concerns were substantial factors in the flour field and that the effect of the acquisitions was substantially to lessen competition. The Commission attorneys emphasized in the hearings that a distinction should be made between the "Sherman Act test" for the illegality of mergers and the new "Section 7, Clayton Act test." Congress had declared, they stated, that the revised Section 7 was to bar piecemeal acquisitions which are not forbidden by the Sherman Act (as interpreted by the courts).

The Sherman Act test, we have seen, is essentially whether or not the acquisition gives the dominant acquiring firm an overwhelming percentage control of the total market. Where a large concern extends its power by successively acquiring small competitors, the individual acquisitions are considered to fall short of Sherman Act violations (under existing decisions). The result, however, is the disappearance of significant competitors and the creation of oligopoly. Only very small, local companies remain as independents.

Small, successive acquisitions are often not impressive, but the cumulative effect of the purchases is to convert an industry of numerous independents into one of oligopoly. This process of gaining economic control is sometimes

[22] For a detailed analysis of the law on exclusive dealing, as well as for a discussion of its commercial use, see *Report of the Attorney General's National Committee to Study the Antitrust Laws* (Washington, D.C., 1955), pp. 137–149.

called the "salami theory." By taking small slices, one can eventually secure a large part of the supply. Sherman Act complaints may thereupon be issued, but the record on dissolution and divestiture suits does not hold much promise.

INCLUSION OF "RULE OF REASON" IN SECTION 7 CASES

The hearing examiner in the Pillsbury case gave an initial decision April 22, 1953, dismissing the complaint. In his opinion, the evidence presented by the Commission's attorneys did not prove a substantial lessening of competition in the total market for flour. The hearing examiner construed the language of Section 7, "substantially to lessen competition," to mean the acquisition of an overwhelming control of the total market. By this construction, Section 7 was interpreted, like the Sherman Act, to prohibit only unreasonable restraints of trade.

The Commission attorneys appealed the initial decision to the Commission, itself. They urged that the "substantiality test" should be used in Section 7 cases, that is, "where a leading factor in the relevant market having a substantial share of that market, acquires another factor in that market also having a substantial share of that market."

On December 28, 1953, the Commission issued an order holding that the evidence in the Pillsbury case established a *prima facie* case of illegality. The case, thereupon, was remanded to the hearing examiner with instructions to hear the case and put all of the evidence in the record. In the Commission's view, the proper test for Section 7 cases lies somewhere between the standard proposed by its own attorneys and the Sherman Act test used by the hearing examiner. The Commission refused to accept the "substantiality doctrine" urged by its attorneys, on the ground that the Commission itself should examine all relevant factors ("rule of reason"). At the same time it rejected the Sherman Act test (overwhelming control), stating that "the Clayton Act requires a lower standard of proof" than the Sherman Act.[23]

On February 19, 1959—almost seven years after the complaint was issued—the hearing examiner issued a decision in the Pillsbury case, holding that the acquisitions of Pillsbury had violated Section 7 of the Clayton Act, as amended. The decision directed Pillsbury to sell the assets acquired to some firm or firms smaller than Pillsbury.

The Pillsbury case can be appealed to the Supreme Court, and it may take a number of years for a final determination to be made. In the meantime, the business operations of the competitors acquired have been completely merged with Pillsbury's operations. Pillsbury has the customers, the salesmen, and the good will. The only thing that it can be forced to sell is the factories themselves, and it is unlikely that anyone will want to buy bare

[23] In the Matter of Pillsbury Mills, Inc., Docket No. 6000, *Opinion of the Commission*, December 28, 1953.

factories, as such. Thus, the victory, after years of delay, is likely to have small, if any, economic significance.

The Pillsbury case points up vividly the need for supplemental legislation requiring corporations planning to merge to provide the antitrust agencies with advance notice of the transaction and to wait for a period of time before consummating the transaction (see Figure 29). The legislation should also give the Federal Trade Commission power to seek a court injunction to restrain a proposed merger, pending proceedings before the Commission. Once a corporate merger has been consummated and business relations commingled, experience has shown, it is exceedingly difficult, and sometimes impossible, to restore the prior status.[24]

Proposals in Congress to require corporations to provide the antitrust agencies with premerger notification have faced strong opposition. This opposition has come from the representatives of large business firms and organizations of large business firms.

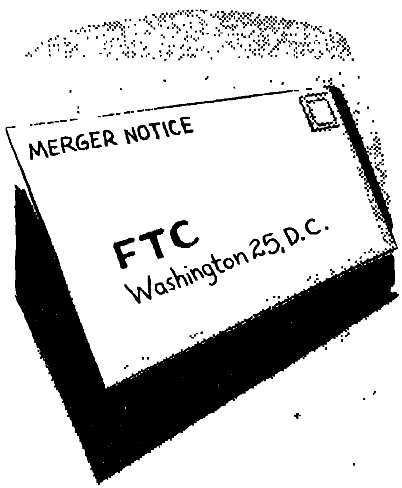

FIGURE 29. Need for Notification of Plans to Merge. Experience in enforcing Section 7 shows the need for requiring corporations to provide advance notification of plans to merge and to wait for a period of time before consummating the transaction. When business relations have been unified, divestiture of plant assets is difficult or is likely to be without economic significance. (Source: *IUD Digest*, Fall, 1959)

PROHIBITIONS ON INTERLOCKING DIRECTORATES

As a further means of preventing restraints on competition in their incipiency, Congress provided in Section 8 of the Clayton Act that interlocking directorships in competing corporations of certain size shall be illegal. When a person is on the board of directors of two or more corporations, he is in a position to help shape the activities of the several concerns so as to avoid price competition. It was this possibility which Congress sought to prevent. Section 8 accordingly provides that no person shall be a director in two or more corporations (other than banks and common carriers) if any one has capital, surplus, and undivided profits in excess of $1,000,000 and if such corporations are competitors. The law does not require the government to find that the interlocking arrangement reduces competition. The fact

[24] See also *Prenotification of Merger*, 85th Congress, first session, House Report 486, May 28, 1957.

of the interlock, itself, makes for illegality. With respect to banks, the law provides that no director, officer, or employee of a bank "operating under the laws of the United States," under certain conditions, shall be connected with another bank in the federal system; and no director, officer, or employee in a private or state bank, under certain conditions, may be a director in a bank operating under the laws of the United States.

The provision in the Clayton Act prohibiting interlocking directorates among industrial and commercial corporations has not been of much value. When a case is brought, it is usual for the director or directors involved to resign from the board of the other corporation, so that no issue exists. If, by chance, a director should refuse to get off the board of a competing corporation, the law is effective in compelling a resignation.[25]

In the main, however, the provision prohibiting interlocking directorates is inadequate because it can be, and is, so easily evaded. The president or treasurer (not a director) of one company, for example, may serve as a director in a competing company. This is an interlocking relationship but not an interlocking directorate. A director of one corporation, moreover, may be represented on the board of a competing corporation by one of his relatives or by his lawyer or accountant. The law may also be evaded if each of two competing concerns has a director on the board of a third corporation—an "indirect" interlock. The Clayton Act further omits any reference to the interlocking relationships among industrial concerns and banks, or among industrial and commercial concerns related as buyer and seller. In each of these situations, interlocking directorates may serve to restrict competition or to prevent arm's-length bargaining.

ADDITIONAL PROVISIONS OF THE ROBINSON-PATMAN ACT

The chain store investigations conducted by the Federal Trade Commission showed that large corporate buyers secured discriminatory low prices not only on the pretense of quantity discounts but also by getting rebates for brokerage services when no actual brokerage services were rendered.[26] In marketing, many manufacturers use brokers in selling to wholesalers and large retailers. The broker represents the manufacturer and is paid a commission (for instance, 2 percent) on the manufacturer's price (for example, $10). The practice of some chains was to buy direct and demand the brokerage fee as a deduction (which would mean 20¢ off) from the manufacturer's price which all other buyers, using brokers, paid. Section 2 (c), which was enacted to remedy this situation, provides that "it shall be unlawful for any person engaged in commerce . . . to pay or grant, or to receive or accept,

[25] *U.S.* v. *Sears, Roebuck and Company*, 111 F. Supp. 614 (1953).

[26] Federal Trade Commission, *Final Report on the Chain Store Investigation*, 74th Congress, first session, Senate Document 4, December 14, 1934, p. 62.

anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, *except for services rendered in connection with the sale or purchase of goods, wares, or merchandise*" (italics supplied). All such allowances are prohibited as such, except for services actually rendered, regardless of their effect upon competition.

An example of the type of problem arising under Section 2 (c) is found in the Great Atlantic & Pacific Tea Company case (1939). After the enactment of the Robinson-Patman amendment, the company directed its field buyers to reduce their buying prices by the amount of the brokerage. The company maintained that in buying direct from first-hand producers it saved the expense of a broker. The Commission and subsequently the Court of Appeals, however, rejected this view on the ground that an employee of the buyer cannot render services to a seller. In the words of the Court, "The agent cannot serve two masters, simultaneously rendering services at an arm's length transaction to both. While the phrase, 'for services rendered,' does not prohibit payment by the seller to his broker for *bona fide* brokerage services, it requires that such service be rendered by the broker to the person who has engaged him. In short, a buying and selling service cannot be combined in one person."[27]

Section 2 (c) serves to protect sellers from coercive demands made by large buyers who may be in a position to exert economic pressure. It also insures smaller buyers that they will be treated uniformly and pay the same net price as other buyers.

Sections 2 (d) and 2 (e) of the Robinson-Patman amendment are concerned with the granting of allowances, discounts, services, or facilities to buyers for promotional and advertising purposes—including newspaper, magazine, and radio advertising; window displays; handbills; and the furnishing of demonstrators. All such allowances, it is provided, must be granted on "proportionately equal terms" to large as well as small purchasers. The purpose of this requirement, the Senate report stated, was to prohibit discriminatory low prices granted to the chain stores under the pretense of advertising allowances. The prohibition in these instances requires no proof of injury and permits no defense by cost.

Senator Logan, who had charge of the legislation on the Senate floor, explained the application of Sections 2 (d) and 2 (e) as follows: "But if the seller grants an advertising allowance to one customer there is no reason why he should not grant, under identical circumstances, the same allowance to another customer based upon the quantity of the purchases. If one man buys $100,000 in goods and should be allowed $1,000 for advertising purposes, and another buys $10,000 in goods, he ought to be allowed $100 for advertising. That is not prohibited by the bill. So long as the same advertis-

[27] *Great Atlantic & Pacific Tea Co.* v. *FTC*, 106 F. (2d) 667, 674-675 (1939). See also *Southgate Brokerage Co.* v. *FTC*, 150 F. (2d) 607 (1945). For further analysis of the provision on brokerage fees, see Russell Decker, "Antitrust Actions in Buyer-Seller Relationships Since 1950," *Drake Law Review*, December, 1954, pp. 8–10.

ing allowances are made proportionately on the amount of purchases there is no prohibition in the bill against them."[28]

Section 2 (f) of the Robinson-Patman Act provides that it shall be unlawful for a *buyer* of commodities "knowingly to induce or receive a discrimination in price prohibited" by the act. This provision supplements Sections 2 (a), (d), and (e), which extend the prohibition to *sellers*. In construing this section, the Supreme Court has held that a buyer, to be guilty of "knowingly" inducing or receiving injurious discriminations, must (1) know that he is getting a lower price than competitors are paying and (2) know that the lower price cannot be justified by cost savings. In substance this means that if a buyer asks no questions on cost savings in relation to the lower prices, he can keep himself clear of the law. Upon the basis of the present interpretation of Section 2 (f), it appears that large buyers are largely unrestrained in using their financial power to gain lower cost prices than smaller competitors are able to secure.[29]

Section 3 of the Robinson-Patman Act provides that certain types of price discrimination shall be criminal offenses, punishable by a fine of not more than $5000 for each violation, and imprisonment for not more than a year, or both. The enforcement of this section is under the jurisdiction of the Department of Justice. The business practices specifically prohibited by Section 3 are (1) participation by any person in any transaction "which discriminates to his knowledge against competitors of the purchaser," (2) the sale of goods in *one sales area* at prices lower than in *another area* for the purpose of eliminating a competitor, and (3) the sale of goods at *unreasonably low* prices for the purpose of eliminating a competitor.

Section 3 of the Robinson-Patman Act lay unused from 1936 until 1948. On July 30, 1948, however, the Department of Justice filed two criminal cases against a group of dairies in the Chicago area, charging them with becoming a party to a continuing contract with the Great Atlantic & Pacific Tea Company, in which the company was granted a secret percentage rebate, discount, and allowance. Subsequently, in 1952, the government dropped the cases because of inadequate evidence.

THE ROBINSON-PATMAN ACT AND FAIR COMPETITION

The Standard Oil of Indiana case crystalizes the conflict of thinking on the meaning of the word "competition." There is general agreement that

[28] *Congressional Record*, March 3, 1936, Vol. 80, p. 3116.

[29] *Automatic Canteen Co. of America* v. *FTC*, 346 U.S. 61 (1953). In this decision, the court ruled against the Commission in its charge that Automatic Canteen had induced suppliers of candy, gum, and nuts to grant it lower prices than competitors paid. Some items, the Commission had found, were sold to small firms at prices 33 percent higher than to Automatic Canteen. The court held that the Commission must prove that (1) the lower prices were not justified by cost savings and (2) the buyer knew that they were not justified by cost savings. In most cases, it is generally believed, this places an impossible burden of proof upon the Commission.

the policy of competition is a desirable one for government to maintain. The Supreme Court itself in the Standard case declared: "The heart of our national economic policy has long been faith in the value of competition." But what does "competition" mean?

Today, Congress, the administrative agencies, and the courts are faced with the problem of employing *some* concept of competition in giving effect to our declared national policy. Two main concepts are available for choice. One is the idea of "fair competition." This concept was developed in the early law on open markets; in the legislation of Congress against discrimination adopted in 1887 (ICC Act), 1914 (Clayton Act), and 1936 (Robinson-Patman Act); and in the writings of many American economists, beginning with J. B. Clark's pioneer work, *The Control of Trusts* (1901). In developing this concept of competition, economic and legal experts defined the term with reference to markets in which (1) transactions are made openly and publicly, (2) all persons have the right to buy and sell, and (3) each seller treats all of his buyers essentially alike. This standard or ideal for public policy is not the pure or perfect competition of textbooks. It is rather the kind of competition which is found in central and primary markets like the Chicago grain market, the Boston wool market, and the Yakima apple market.

The other concept of competition had its origin (1) in circles using monopoly practices and (2) with attorneys and economists defending private corporations against charges of monopoly and unfair competition. Its essential aspects are to be found in legal briefs; in the writings of various legal and economic experts; and, finally, in the Standard Oil of Indiana decision (1951). Its adoption has been—and is being—pressed by attorneys and economists employed in defending private corporations against monopolistic charges. Competition, in this view, is an unlimited, unrestricted activity, waged without rules and penalties, and legitimate as long as it is pursued in good faith to make profits. Local price cutting, price raiding, and price discrimination are all legal methods of competition. Discrimination, it is said, is fundamental to the competitive system. One cannot complain about the injuries which discrimination brings if a policy of competition is to be maintained. Any restriction on discrimination is a restriction on competition.

DISCRIMINATION AS A TOOL OF MONOPOLY

In the Clayton and Robinson-Patman Acts, Congress declared that price discrimination is not a competitive practice but, on the contrary, is a monopolistic practice. Discrimination was recognized as a device by which monopoly grows and advances itself. The purpose of the legislation of 1914 and 1936 was to condemn discrimination and thus to strike at monopoly in its incipiency.

Price discrimination is a *limited* kind of competition which works in two ways to create monopoly. First, in cutting prices in one locality, a discrimi-

nating seller is able to make up the lower prices on other sales. This an independent, single-plant competitor cannot ordinarily do. Local, *small-sized competitors* are injured, irrespective of their efficiency.

Secondly, in discriminating among *its customers*, a discriminating firm places some—those paying the higher price—at a disadvantage in relation to others—those paying the lower price. Nondiscriminatory treatment of customers at the mill, however, affords small and big buyers a comparable purchasing price. All such persons buying for resale are thus given an equal start, *as in a real market*. This is the essential purpose of the Robinson-Patman Act.

Modern-day advocates of discrimination urge that discrimination be permitted, even if competition is destroyed, so long as it is done in "good faith." In support of their position, advocates of discrimination state that the Sherman Act stands for "hard" competition (discriminatory pricing); whereas the Clayton Act, as amended, calls for "soft" competition (nondiscriminatory pricing). Those defending the Clayton and Robinson-Patman Acts, on the other hand, maintain that, in truth, price discrimination is a "soft" kind of competition (for a monopolistic seller), because it relieves a seller of the need to reduce his prices uniformly to all customers (see also Glossary of Terms at the end of this chapter).

The Clayton and Robinson-Patman Acts, their supporters maintain, are fully compatible with the Sherman Act. The Clayton Act, as amended, applies only to the prices of *one* seller. It strikes primarily at the *effects* of local and limited monopoly (incipient and attained), particularly price discrimination, as practiced by a single seller. Section 1 of the Sherman Act, on the other hand, applies to the prices of *a group* of sellers. It condemns conspiracy and unified selling which give rise to monopoly power, including the power to discriminate. Each law has for its purpose the creation and maintenance of fair and open price competition. Each stands for the principle that business survival should be based upon economic efficiency. A dominant firm, with the power to discriminate, can reduce its prices on some sales not because of efficiency, but because it can recoup its losses elsewhere. It is only when discrimination is restrained that business rivalry can operate as a "contest of efficiency" in which the more efficient have a chance to succeed.

THE NEED TO RESTUDY THE PRACTICE OF PRICE DISCRIMINATION

Vast amounts of public testimony, commission investigation, and legal analysis with respect to discrimination have led to the declarations of national policy in 1887, 1914, and 1936, condemning price discrimination as a monopolistic measure. Historically, the view of Congress has been that the law should protect competition—that it should not condone anything

which would injure competition. The Standard Oil decision vitiates this principle. Someday Congress must decide anew whether (1) the law should permit price discriminations which injure competition or (2) the law should restrain injurious price discriminations.

Various business groups—especially large multiplant companies—vigorously press for the privilege of discriminating in price, regardless of injury to competition. The cutting of prices (mill net returns) to a few customers and not to others is more profitable than that of making a general reduction to all customers. It also gives a dominant seller the power to charge higher prices in some areas (where competition is not active) and lower prices in other areas (where small, independent competitors are operating).

Small business firms declare that price discrimination is an unfair method of competition which violates the principle of equal opportunity for all. In their view, competition should be regulated by restraining price discriminations which destroy competition (to be achieved by amending the Robinson-Patman Act). At the same time, the Sherman Act should be applied to dissolve concentrated economic power (a chief source of the ability to discriminate). The Robinson-Patman and Sherman Acts, it is said, should *both* be applied to a given industry. Failure of government to do so, they emphasize, means the abandonment of our declared policy of fair competition.

The basic problem which must be grasped by the courts and the people is the significance of the practice of price discrimination. Is it the kind of competition which we want? The law, as presently construed, permits or tolerates a substantial amount of discrimination. In large measure, the nation is back to the conditions of 1900 when discrimination flourished unchecked. Today, we must again relive and restudy the business practices of discrimination and decide anew the prohibitions to be made.

Glossary of Terms

"*Hard Competition.*" Price discrimination which is not restrained or restricted by legal rules. A discriminator can bear down "hard" in his price cutting, in the absence of a legal prohibition on discrimination, because he is able to charge more elsewhere. This term describes a *limited* kind of competition, limited to certain customers or places. It is not the kind of competition found in central markets.

"*Soft Competition.*" Rivalry in selling, advocates of price discrimination declare, in which the right to make "price cuts" is curbed by the Robinson-Patman Act.

The terms "hard" and "soft" competition were developed by persons in favor of price discrimination. Supporters of the Robinson-Patman Act condemn hard competition as defined above. In their view, it is competition of the jungle type, waged without fair rules of the game.

The notion of soft competition, they add, is fallacious. Section 2 of the Robinson-Patman Act in no way restricts a seller in making price reduc-

tions which are uniform to all buyers at the mill, with reasonable differentials for differences in services, quality, or costs involved. Such price reductions are, in fact, the very essence of real competition. No supporter of the antitrust laws would propose to curb them.

15

Basing-Point and Zone-Delivered Pricing Systems—and Their Legality

One of the most important applications of the Federal Trade Commission and Clayton Acts, as amended, is found in the basing-point cases. These cases have created a tremendous amount of controversy on the nature and meaning of competition. Today, basing-point and zone systems are described by their critics as "the chief instrument by which American cartels exercise a control over prices" and by their advocates as "a business practice which promotes competition and benefits buyers."

The use of delivered-pricing systems in the American economy continues to be widespread. Arguments for and against such pricing methods, moreover, are continually being made in the press, trade journals, corporation reports, the *Congressional Record*, as well as in complaints filed with the antitrust agencies.

The Supreme Court, in a series of decisions culminating in the Cement decision (1948), declared that the basing-point practice is a monopolistic method of pricing. Basing-point industries thereupon appealed to Congress for legislation to legalize the practice. At present, Congress and the American people face the problem of deciding what to do about pricing systems.

THE DEVELOPMENT OF BASING-POINT SYSTEMS

Although the basing-point plan was first used as early as 1880, its systematic and continuous use appears to have come with the creation of the United States Steel Corporation in 1901. The formation of the Corporation, "a combination of combinations," placed in the hands of one management a control over the major combinations then existing in the steel industry. If the Corporation had continued to quote uniform f.o.b. mill prices at its separate mills, freight costs would have given certain mills advantages over others in selling at various centers of consumption. In order, therefore, to avoid giving mills located near a consuming center an advantage in getting

business, the Corporation in 1901 adopted the practice of selling all iron and steel products, except rails, at delivered prices only.

The delivered prices quoted by the Corporation were the sum of a base price at Pittsburgh plus rail freight from Pittsburgh to the destination, regardless of the actual origin of shipments or the actual freight cost incurred. All steel mills—those controlled by the Corporation as well as independents—followed the lead of the Corporation in quoting delivered prices on the basis of "Pittsburgh-plus," even though they made and sold steel locally (as in Chicago) or shipped it from a distance into the neighborhood of Pittsburgh (see also Chapter 7, pages 133–135).

DELIVERED-PRICING SYSTEMS BECOME WIDELY USED

Soon after the adoption of the basing-point plan in the steel industry in 1901, the practice was extended to the cement industry. Outside of steel and cement the practice was little used until around 1912, after which time its use spread rapidly. Some examples of commodities in addition to iron and steel which came to be sold on a *single* basing-point plan include cast-iron soil pipe, glucose, malt, maple flooring, welded chain, zinc, lead (St. Louis plus freight differentials), and copper ("Connecticut Valley" plus freight differentials). In certain industries two or more bases were established by the price leaders. Some of the products which came to be sold on a *multiple* basing-point system include iron and steel after 1924, cement, hardwood lumber, gasoline, sugar, chemical fertilizers, milk and ice-cream cans, asphalt roofing material, small arms ammunition, corn products, gypsum products, hard-surface floor coverings, linseed oil, rigid steel conduit, firebrick, lubricating oil, and plate glass.

At present, it is a common practice for *each* geographically separate mill to quote a local f.o.b. mill price for nearby sales and then to reduce its mill net price on distant sales (by absorbing freight) to meet the delivered prices of distant sellers. This practice is variously called "competitive freight absorption" and "f.o.b. selling with freight equalization."

THE FREIGHT-ALLOWED OR ZONE-DELIVERED PRICING SYSTEM

The freight-allowed method of pricing appears to have been first used in the sale of tobacco products. Its use in this field came with the formation of the American Tobacco Company in 1890. During the period 1890–1900 such products as water meters, wire rope, retail scales, meat slicers and choppers were sold in this way. From 1900 to 1904 more products were added to the list, including pipe tools, vises, pipe cutters, auger bits, wood-boring tools, screw drivers, and machine knives. From 1908 to 1910 the

practice spread to automobile tires, brake lining, and chemical products. In 1912 manufacturers of tire chains and electric lamps began to sell their products with an allowance of freight. With the legalization of price fixing during the National Recovery Administration (1933–1935), many more products were quoted on this basis. Today, the practice is used in scores of industries, ranging from aluminum, cadmium, high-grade zinc, and other metals, to typewriters, gasoline service station pumps, cigarettes, firearms, liquid chlorine, paper bags, and glass containers.

METHODS USED TO MAINTAIN DELIVERED-PRICING SYSTEMS

If demand declines and sales fall off, or if a desired volume of business cannot be done at the controlling base prices, some mills (usually single-plant competitors) are tempted to deviate from the delivered-price system by quoting lower prices *in certain areas or to selected customers* in order to increase their business. As soon as knowledge of the price reductions becomes known to other sellers, the evidence shows, the price leader takes immediate steps to discipline the mill showing a price independence. One method used by price leaders in basing-point industries is to impose a "punitive base price" on the mill competing on price. This means that the price leader, regardless of his location, will announce and quote a very low base price at the mill showing troublesome competition.

In the hearings of the Federal Trade Commission on the cement industry, the evidence presented showed that the imposition of a punitive base price quickly makes a recalcitrant ask for terms. Thus, the president of a cement mill in Nebraska, which had been competing on price, found that a low base price had been imposed on his mill and wrote to the price leader: "While in Omaha yesterday, I found that you had placed a base on our Nebraska mill, and you may imagine my surprise to find you had done a thing like that. . . . If you had hired a man to stab me in the back, or burned our plant, I wouldn't be more surprised than I am at what you have done. . . . I cannot take such action on your part as other than a deliberate attempt to ruin our business." The price leader replied that he would be "glad to confer . . . in person," and in due time arrangements were made to have the punitive base price removed.[1]

A second disciplinary measure employed by a price leader against a mill which tries to compete on price is "price raiding." Price raiding means that delivered prices are cut in particular local areas, or to particular customers, in a *discriminatory way*, expressly to injure the concern showing a price independence. In cutting prices to discipline an independent, the price

[1] *FTC* v. *Cement Institute et al.*, *Brief of Respondents*, United States Court of Appeals for the Seventh Circuit, October Term, 1945, Vol. 1, p. 504–505.

leader may, and frequently does, instruct its salesmen to "get the business" by quoting any price which is necessary to do it. Such prices are variously called "special" or "arbitrary" prices. The resulting price chaos is usually known as a "price war." The ability of a price leader to cut price to extremely low levels in certain areas is based either upon financial strength or upon monopoly control in other areas in which the losses may be recouped.

THE PITTSBURGH-PLUS CASE (1924–1948)

It was not until 1921 that the government began to prosecute pricing systems as a special device of monopoly. This delay is to be explained by the fact that government authorities did not immediately comprehend the nature or meaning of the pricing systems and their use in restricting price competition. The practice of cutthroat competition (local price cutting) was well understood, and Congress took action to prohibit its use in the Clayton Act (1914). The more subtle forms of systematic discrimination, however, which had largely come to displace cutthroat competition, remained unnoticed or were not understood.

When the Federal Trade Commission finally issued a complaint against the United States Steel Corporation in 1921 for using the Pittsburgh-plus system of pricing, it did so not because of its own investigations and convictions but rather because of the complaints of certain midwestern fabricators who were being injured by the practice of charging phantom freight in the sale of steel products.

The complaint issued by the Federal Trade Commission in the Pittsburgh-Plus case charged the United States Steel Corporation and its subsidiaries with a violation of Section 5 of the Federal Trade Commission Act and Section 2 of the Clayton Act. In the main, the case centered on the presence of discriminations in price which injured competition among the buyers of steel products, as well as among the sellers. Buyers in the area of Chicago, for example, were required to pay $7.60 a ton phantom freight—the freight "plus" from Pittsburgh—on steel produced by the local subsidiaries of the Corporation. Independent steel mills likewise observed the Pittsburgh-plus formula in a plan of following the leader on price. With this extra cost burden, fabricators of steel in Chicago could not ship eastward to any extent, for their prices were substantially higher than those of the Pittsburgh fabricators who did not have to pay the phantom freight. A number of steel users in the Middle West, it was found, had been forced to discontinue the manufacture of a variety of steel products because of higher costs. The Commission estimated that imaginary freight charges included in the prices of farm implements made in the Chicago area cost farmers in eleven western states around $30,000,000 annually.

In attempting to defend its practice of selling steel products at a Pittsburgh base price plus the rail freight from Pittsburgh, regardless of their

origin, the Corporation developed the so-called "surplus-deficit" argument. The area around Pittsburgh, it was said, was a surplus area for steel, and all other areas were deficit areas. Upon the basis of this premise, the Corporation reasoned that the delivered cost in other regions—such as around Chicago or Pueblo—must necessarily be the Pittsburgh price plus the full freight from Pittsburgh, in order to attract a flow of steel products from Pittsburgh.

The economic experts employed by the Commission answered the Corporation by pointing out that in accordance with this hypothesis, primary steel products produced in the Middle West would not flow eastward into an area of surplus. Actually, however, the records showed that steel products produced by various mills in the Chicago area were regularly shipped eastward to Pittsburgh and beyond. The facts were that the Corporation was maintaining a high monopolistic price level for steel products (which other mills faithfully followed) and that its subsidiaries and other western mills thereupon "dumped" surplus supplies at lower *net realized* prices on sales eastward into the "surplus" area.

Upon the basis of its findings, the Commission ordered the United States Steel Corporation to cease and desist the use of the Pittsburgh-plus method of pricing. The Corporation accepted the order without appeal to the courts and promised to comply "in so far as it is practicable to do so." In fact, the Corporation made only a gesture to comply with the Commission's order. A few new basing points were established, but the new base prices were related to the Pittsburgh base plus the rail freight. In substance, the new plan of pricing became a formal multiple basing-point system with the various base prices equal to the Pittsburgh base plus all or part of the freight from Pittsburgh.

In 1938, with the enactment of the Wheeler-Lea amendment to the Federal Trade Commission Act, it was provided that all orders of the Commission would automatically become final and enforceable, unless carried to a Court of Appeals within sixty days. On May 18, 1938, the Corporation filed a petition with the Court of Appeals in Philadelphia, asking the Court to set aside the Commission's order of 1924.

The Pittsburgh-Plus case remained pending in the Court from May 18, 1938, until October 5, 1948, when the Corporation consented to sign a "decree of affirmance and enforcement" of the order issued by the Commission in 1924. The long delay in bringing the case to a close is to be explained largely by the fact that neither the Corporation nor the Commission was eager to have the case come up for trial. The Corporation, of course, was pleased to postpone action, for delay meant that it could continue to use the basing-point system with impunity. The Commission, on the other hand, was willing to grant delay in expectation of securing favorable court decisions in cases which it had pending against the glucose, cement, and conduit industries. It was possible that the very size and magnitude of the steel industry might make the courts unwilling to "upset the applecart"; but with

favorable decisions and precedents in other industries, the case against steel would be impregnable.

The Commission, in fact, was successful in winning its cases in other industries, and the Corporation in October, 1948, saw no alternative but to sign a consent decree. The order of the Commission, which the Corporation agreed to observe, provides in substance that the Corporation will refrain (1) "from quoting . . . rolled steel products upon any other basing point than that where the products are manufactured or from which they are shipped" and (2) "from selling . . . such steel products . . . without clearly and distinctly indicating . . . how much is charged for such steel products f.o.b. the producing or shipping point, and how much is charged for the actual transportation of said products."[2]

Today, in observing this decree, the Corporation offers to sell steel products f.o.b. its mills. However, it at the same time follows the practice of offering to meet the base price plus freight of a distant competitor, if this combination price is lower. Thus, the Corporation in fact continues to employ basing-point pricing (see below, pages 349–350).

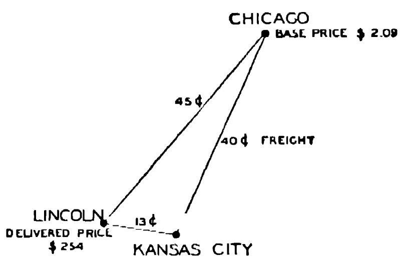

FIGURE 30. The Basing-Point System Condemned by the Supreme Court in the Corn Products Case. The Corn Products Refining Company has plants in Chicago and Kansas City. Its pricing policy was to sell glucose at a Chicago base price plus rail freight from Chicago to the customer's location, even though the product was made in Kansas City and sold in adjoining territory.

THE CORN PRODUCTS CASE (1945)

The Corn Products Refining Company is the largest manufacturer of corn product derivatives in the United States, with plants in Chicago and Kansas City. The company established a base price for glucose at Chicago ($2.09 per unit of 100 lbs.) and sold its output at both plants at the Chicago base price plus rail freight from Chicago. Customers in Kansas City bought glucose from the local plant and were charged a delivered price of $2.49 per unit, of which 40¢ was phantom freight (see Figure 30). In selling in Lincoln, Nebraska, the company charged customers a freight item of 45¢ per unit although the actual freight from Kansas City was only 13¢. On such sales the company collected phantom freight of 32¢ per unit.

In its decision in the Corn Products case, the Supreme Court found that the company's use of the basing-point formula in the sale of glucose *"results inevitably in systematic price discriminations*, since the prices they receive

[2] *U.S. Steel Corp.* v. *FTC, Decree of Affirmance and Enforcement,* United States Court of Appeals for the Third Circuit, October 5, 1948.

upon deliveries from Kansas City bear relation to factors other than actual costs of production or delivery." On some shipments the plant at Kansas City collected phantom freight, and in other cases it engaged in freight absorption. "This difference," the Court observed, "results in varying *net* prices to petitioners at their factory at Kansas City, according to the destination of the glucose. The *factory net* varies according as petitioners collect phantom freight or absorb freight, and in each case in the amount of this freight differential."[3]

Whether or not discrimination in price stands condemned by Section 2 (a) of the Clayton Act, the Court observed, depends upon whether the effect of such discrimination is substantially to lessen competition. Upon the basis of the record, the Court found injury to competition in that buyers of glucose in Kansas City and numerous other cities were forced to pay substantial amounts of phantom freight which their competitors in Chicago did not have to pay. Some of the buyers of glucose were candy manufacturers who sold their products nation-wide, and the Court found that a fictitious freight charge ranging up to 40¢ per unit of glucose increased their costs and substantially lessened their ability to compete.

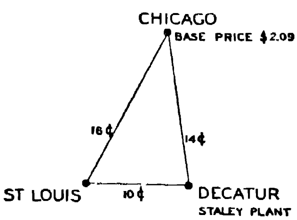

FIGURE 31. The Basing-Point System Condemned by the Supreme Court in the Staley case. The Staley Manufacturing Company is a producer of glucose located at Decatur, Illinois. Its pricing policy was to quote the Chicago base price plus freight from Chicago to the customer's location. A customer St. Louis was charged 16¢ freight, while a customer in Chicago was charged no freight at all.

THE STALEY CASE (1945)

The Staley case likewise involved the sale of glucose at a Chicago base price plus rail freight from Chicago. The Staley Manufacturing Company, a producer of corn products located at Decatur, Illinois, adopted the pricing system of the Corn Products Refining Company and sold its products as if they had been produced in Chicago. Customers in St. Louis (see Figure 31), for example, were charged 16¢ per unit for freight, although it cost the company only 10¢ per unit to ship glucose from Decatur to St. Louis. On sales in Chicago, the company charged no freight and absorbed a freight item of 14¢ per unit in making delivery. As in the Corn Products case, the Commission charged that the company was engaging in price discrimination —as measured by variations in the mill net price—which substantially lessened the ability of certain customers to compete in the sale of products made with glucose. Such discriminations, the Commission maintained, were prohibited by Section 2 (a) of the Clayton Act.

The Court condemned Staley's pricing system on the ground that it re-

[3] *Corn Products Refining Co.* v. *FTC*, 324 U.S. 726, 732–733 (1945). Italics supplied.

sulted in injurious discrimination among Staley's customers.[4] The Staley decision is a landmark because (1) it sets out a definition of price discrimination (variations in a seller's mill-net returns); (2) it holds that systematic price discrimination to match another's delivered price is not discrimination "in good faith"; and (3) it condemns systematic price discrimination whenever there is injury to competition.

BASING-POINT PRICING AND SECTION 5 OF THE FEDERAL TRADE COMMISSION ACT

Section 5 of the Federal Trade Commission Act has been interpreted by the courts to prohibit concerted action in price-making. The Commission has utilized this provision of the law in its efforts to prohibit the use of pricing systems. In the Malt case, decided in 1945, the Court of Appeals upheld the Commission in an order issued under Section 5 against some eighteen manufacturers of malt. The various defendants located at different production points sold malt at identical delivered prices. Each producer quoted the base price at Chicago plus rail freight from Chicago to the customer's location, regardless of the point of origin or the actual freight cost incurred. The Commission found that the action of the respondents in quoting identical delivered prices in accordance with the basing-point formula was based upon agreement and prohibited by Section 5 of the Federal Trade Commission Act, and the Court of Appeals upheld the Commission.

Although there was little, if any, direct evidence of an express agreement in the Malt case, the Court of Appeals held that such proof was not necessary. "The agreement," said the Court, "may be inferred or implied from the acts and conduct of the parties as well as circumstances pertinent thereto." Upon reviewing the use of the basing-point system by the respondents to quote identical delivered prices, the Court concluded that "it is difficult to discern how the various steps necessary to produce the result could have been taken with such meticulous care and regularity in the absence of an agreement."[5]

The Milk Can case, decided in 1946, involved the use of a multiple basing-point plan in the sale of milk and ice-cream cans, with every mill serving as a basing point. The Commission found that the respondents maintained a plan of freight equalization in order "to match competitor's prices," with the result that "the delivered cost of their products was the same, regardless of from whom purchase was made or from which producing point the goods purchased were shipped." Industry members maintained that their pricing system did not result from any combination or agreement, and that its use

[4] *FTC* v. *A. E. Staley Mfg. Co.*, 324 U.S. 746 (1945).
[5] *U.S. Maltsters Assn.* v. *FTC*, 152 F. (2d) 161, 162, 165 (1945).

promoted competition. The Commission, however, found considerable evidence to indicate the existence of a "planned common course of action" and issued an order condemning the pricing system. The Court of Appeals subsequently upheld the Commission's finding of agreement to fix prices in violation of Section 5.[6]

The Crepe Paper case (1946) involved the use of a zone-delivered pricing system by the principal producers of crepe-paper products. The country was divided into three zones for pricing purposes, and uniform prices were established in each zone. Industry members sought to defend their pricing system by declaring that identity in price was the result of keen competition—not agreement. The Commission and subsequently the Court of Appeals, however, rejected this defense on the ground that the industry's use of a zone-delivered pricing system was based upon agreement, actual or implied. In upholding the Commission, the court declared: "We think the artificiality and arbitrariness of the zone structure is so apparent it cannot withstand the inference of agreement."[7]

THE CEMENT CASE (1948)

The Cement case was started by the Federal Trade Commission in 1937, and hearings were conducted before the trial examiner during a period of three years. The record of the case, as presented to the Supreme Court, consisted of some 49,000 pages of testimony and 50,000 pages of exhibits. The findings of the Federal Trade Commission itself covered over 175 pages. Never before had the Federal Trade Commission made such a complete and thorough investigation of a basing-point industry.

The facts in the Cement case showed that about one-half of the cement mills in the United States were located at basing points. The nonbasing-point mills sold their products at the base price and the freight rate of some other mill. Delivered prices at any destination point were found to be identical, regardless of the location of the seller or the actual freight cost incurred.

The Federal Trade Commission charged in Count I of its complaint that the cement producers had restrained price competition in violation of Section 5 of the Federal Trade Commission Act by the *concerted* use of maintenance of the multiple basing-point system of pricing. Count II of the Commission's complaint, as a counterpart to Count I, charged that the respondents were engaged in concerted, systematic price discrimination which substantially lessened competition between and among said respondents, in violation of Section 2 (a) of the Clayton Act.

The Court of Appeals held that the basing-point delivered prices charged by respondents were illegal in so far as they involved the collection of

[6] *Milk and Ice Cream Can Institute* v. *FTC*, 152 F. (2d) 478, 482 (1946).
[7] *Fort Howard Paper Co.* v. *FTC*, 156 F. (2d) 899, 907 (1946).

phantom freight, but declared that discrimination arising in freight absorption was justified by Section 2 (b). The Commission thereupon appealed the case to the Supreme Court.

Count I in the Cement Decision

Justice Black, speaking for the Court in a six-to-one decision, held that the use of the multiple basing-point plan in the cement industry was an illegal method of pricing on both of the counts made by the Commission. With respect to Count I, Justice Black declared: "We sustain the Commission's holding that concerted maintenance of the basing point delivered price system is an unfair method of competition prohibited by the Federal Trade Commission Act."[8] Justice Black characterized the basing-point delivered-price system as "a handy instrument to bring about elimination of any kind of price competition" and stated that there was abundant evidence to show that its use in the cement industry was an unlawful price-fixing conspiracy.

Count II of the Cement Decision

Turning to Count II in the Commission's complaint, Justice Black reaffirmed the decisions of the Court in the Corn Products and Staley cases. In explaining and interpreting these cases, he stated that both the *higher* and the *lower* mill net prices resulting from phantom freight and freight absorption are discriminatory. Repeating a statement from the Staley case, he emphasized: "Since such freight differentials bear no relation to the actual cost of delivery, they are [or result in] systematic discriminations prohibited by section 2 (a) whenever they have the defined effect upon competition." The Court found that the resulting discriminations in the sale of cement did have the defined effect on competition, for their systematic use by multiple sellers in the basing-point plan had the effect of *eliminating price competition between the sellers.* Thus, the Court in the Cement case established the point that systematic freight absorption by multiple sellers is illegal under Section 2 (a) because it was used to match delivered prices and avoid price competition.

The final decree issued by the Court of Appeals in the Cement case—"commanding obedience" to the Federal Trade Commission's order—prohibits the concerted sale of cement at prices determined in accordance with the multiple basing-point delivered-price system or any other plan or system which results in identical price quotations at a customer's location.

THE RIGID STEEL CONDUIT CASE

The complaint in the Cement case was framed in terms of the *concerted* use and maintenance of basing-point pricing. The legal staff of the Federal

[8] *FTC* v. *Cement Institute,* 333 U.S. 683, 720 (1948).

Trade Commission soon recognized that a cease-and-desist order, if secured, would accordingly have to be limited to one denying the *concerted* sale of cement at basing-point prices. Such an order, it was clearly seen, would not curb the use of the basing-point system, as such, in situations in which agreement could not be found. The staff, therefore, sought in the Conduit case (Count II) to reach the *concurrent* use of the basing-point system, on the grounds that its individual use by trade members resulted in denying customers the benefits of price competition.[9]

The Conduit case involved the use of a multiple basing-point plan by fourteen corporate manufacturers of rigid steel conduit, representing over 93 percent of the producing capacity of the industry. Rigid steel conduit is a steel pipe which has been cleaned and enameled or galvanized, particularly on the interior. It is used as a container for electric wiring installed in buildings and other construction projects. The Commission charged in Count I that the respondent manufacturers had formed a conspiracy to fix prices by the adoption and use of a multiple basing-point plan, with bases at Pittsburgh and Chicago.

In Count II, the Commission added the further charge that the petitioners had individually violated Section 5 "through their *concurrent* use of a formula method of making delivered price quotations with the knowledge that each did likewise, with the result that price competition between and among them was unreasonably restrained." Count II, it may be noted, did not rest upon questions of agreement or conspiracy, but rather upon the *concurrent use* of a basing-point system, *with the result that customers were denied the benefit of price competition* and the advantage of their proximity to points of production.

The principal industry witness called upon to testify in the Conduit case on bid identity was Mr. H. S. Walker, head of one of the more prominent conduit manufacturing firms and President of the Rigid Steel Conduit Association. From the testimony of Mr. Walker, it was developed by counsel for the Commission that *there are three underlying basics of identical bidding* (including "administered prices," price leadership, and price following). First, there invariably in the use of some *system* or *method* of behavior by "which uniform prices can be put together."[10] This may consist of a basing-point, zone, or freight-equalization system, or of the outright quotation of another's mill price, with actual freight payable by the buyer. In the Conduit case, the method used was the multiple basing-point system, with bases at Pittsburgh and Chicago.

Secondly, there is the *action* of each seller in making bids, according to the system, knowing that others are doing the same, and knowing also that the natural and foreseeable consequences of this action will be matched bids. Thus, Mr. Walker was asked: "Well, when you use that method and you

[9] Federal Trade Commission Decisions, *Rigid Steel Conduit Association et al., Complaint*, Vol. 38, 1941, pp. 549–550.

[10] In the Matter of *Rigid Steel Conduit Association, et al.*, Docket 4452, Transcript of Testimony, September 29, 1941, p. 883.

know that your competitors are using the same kind of method in figuring their prices, even though you and they submit your quotations under seal, you can anticipate what their prices are going to be as submitted in bids, can't you?" He replied: "If they stick to the method which they publish, we can tell what the price is going to be because it is all published."[11]

Thirdly, there is the *knowledge beforehand,* or at least the expectation, that all sellers will follow the given system or method of pricing, so that agreement is not needed to use the system or to get the results of identical bids. On this point, Mr. Walker was specifically asked by the trial examiner: "Are you able to continue this method without any express agreements with your competitors?" The witness replied: "If I must answer, I will say 'Yes, of course.' We never had any agreements with them. . . ."[12]

So it is that with (1) a given *method* of pricing, (2) its *concurrent use* by industry members, and (3) the *knowledge beforehand* of its use by others, sellers can act without agreement to get the foreseeable results of identical bids.

The Court of Appeals upheld the Commission on Count I and also sustained the finding in Count II that the concurrent use of the basing-point system in the conduit industry was in violation of Section 5 of the Federal Trade Commission Act. In affirming the Commission's order in Count II, the court declared: ". . . each conduit seller knows that each of the other sellers is using the basing-point formula; each knows that by using it he will be able to quote identical delivered prices and thus present a condition of matched prices under which purchasers are isolated and deprived of choice among sellers so far as price advantage is concerned."[13]

In the Conduit case, prosecuted under the Federal Trade Commission Act, counsel for the Commission developed a rationale which serves to explain a large area of identical bids not based upon collusion. Identical bidding, it was shown in Count II, is not an innocent, inevitable, competitive practice which defies all human and legal regulation. It is rather the result of a deliberate, purposeful mechanism used concurrently by industry members, with the knowledge beforehand the others are doing likewise, so that matched bids arise automatically as a natural result.

BASING-POINT DECISIONS GO BENEATH THE SURFACE OF THE MONOPOLY PROBLEM

The existence and understanding of effective, two-sided price competition in many segments of the economy has become a lost art. A considerable number of business leaders, in fact, have never practiced such a form of

[11] *Ibid.*, pp. 894–895.

[12] *Ibid.*, p. 930.

[13] *Triangle Conduit and Cable Co. et al.* v. *FTC,* 168 F. (2d) 175, 179 (1948). This decision was upheld by the Supreme Court by a four-to-four tie vote. *Clayton Mark et al.* v. *FTC,* 336 U.S. 956 (1949).

competition. When the cement industry was told by an official in the Federal Trade Commission in 1948 that it must cease and desist the use of basing-point pricing because this method of pricing was not genuinely competitive, the industry attorney replied: "My clients just do not know what you are talking about."

The record on exemptions from the antitrust laws, as we have seen, indicates that if important antitrust cases are won—that if anything more than the surface is scratched—the business concerns affected go at once to Congress to secure legislative modification. Politically important elements do not wish to have any change in the *status quo,* and tremendous pressure is put upon Congress to set aside the judicial ruling. The point of view taken by the interests concerned is that "established business practices have been going on for a long time, and that they therefore should not be disturbed."

PRESSURE ON CONGRESS TO CHANGE THE LAW

A vast campaign of pressure on Congress was instituted by the basing-point lobby during the years 1948, 1949, and 1950 to legalize the basing-point practice. In the words of Senator Wayne Morse (Oregon), "This lobbying effort was one of the best organized, one of the most heavily financed, and one of the most adroitly deceptive that has ever been addressed to the Congress of the United States."[14]

The goal of the proposed legislation was to legalize the use of discriminatory delivered pricing systems *in the absence of direct evidence of agreement (conspiracy).* Actual conspiracies, as we have seen, are exceedingly difficult to prove; and the basing-point industries want to stop condemnation of the *concurrent* use of pricing systems.

THE PASSAGE AND VETO OF BASING-POINT LEGISLATION

In 1949, Senator O'Mahoney of Wyoming, took the lead in sponsoring legislation to legalize basing-point pricing. During the course of the debates, he openly declared that "one of the purposes which I entertained in offering this provision was to make sure that the system which has been used, without criticism, by the sugar-beet industry, of selling at delivered prices by absorbing freight, should not now be disturbed."[15] Many other Congressional leaders supported the legislation in behalf of the steel, cement, gasoline, and other basing-point industries which were located in their particular geographic areas. Upon the basis of widespread geographic support, Congressional approval of a bill to legalize basing-point pricing (S. 1008) was secured in June 1950.

[14] *Congressional Record,* May 31, 1949, Vol. 95, p. 7028.
[15] *Congressional Record,* June 1, 1949, Vol. 95, p. 7071.

On June 16, 1950, President Truman issued a veto message condemning the basing-point legislation. In his view, the legislation contained confusing and uncertain provisions which might be interpreted as permitting the basing-point practices recently found to be illegal. He declared: "When further amendments of the antitrust laws are needed to meet new problems, they should be enacted in a form which clearly preserves the basic purpose of these laws—the protection of fair competition and the prevention of monopoly."[16]

THE IMPACT OF CONGRESSIONAL PRESSURE ON COMMISSION POLICY

During the year of 1948 the Federal Trade Commission reached the high-water mark in its drive to deal with basing-point monopoly. In April of that year, the Commission called upon industry generally to abandon the use of basing-point delivered pricing systems.[17] In its view, most of the industry-wide pricing systems used to arrive at identical delivered price quotations were probably illegal.

The position taken by the Commission in 1948 on basing-point pricing was soon thereafter modified as a result of Congressional opposition. Congress did not succeed in its efforts to legalize basing-point pricing, but it did succeed in weakening Commission policy. In settling the case (August 10, 1951) against the American Iron and Steel Institute and ninety steel producers, charged with using the basing-point practice, the Commission ordered the Institute and its members to discontinue "any planned common course of action, understanding or agreement" in basing-point pricing. The prohibition applied to *concerted* action rather than to the *concurrent* use of basing-point pricing. In particular, the Commission qualified its order by stating:

1. The Federal Trade Commission is not considering evidence of uniformity of prices or any element thereof of two or more sellers at any destination or destinations alone and without more as showing a violation of law.
2. The Federal Trade Commission is not acting to prohibit or interfere with delivered pricing or freight absorption as such when innocently and independently pursued, regularly or otherwise, with the result of promoting competition.[18]

[16] The veto message appears in *Study of Monopoly Power*, Hearings Before the Committee on the Judiciary, House of Representatives, 82nd Congress, first session, Serial 1, Part 5, 1951, pp. 253–255.

[17] "FTC Warns All Lines to Drop Basing Points," *Journal of Commerce*, April 29, 1948, p. 1.

[18] *Federal Trade Commission* v. *American Iron and Steel Institute et al., Order to Cease and Desist*, Docket 5508, 1951, p. 6. This case was a follow-up to the initial proceeding against the United States Steel Corporation in the Pittsburgh-Plus case. It included substantially all steel producers in the United States.

The foregoing qualifications reflect an almost complete change in the attitude of the Commission toward basing-point pricing. As long as basing-point pricing is done "independently," it appears to be within the law.

DELIVERED PRICES TODAY BASED UPON THE CONCURRENT USE OF A PRICING FORMULA

Many industries are currently employing delivered pricing systems which involve systematic freight absorption and divergent mill net prices. The steel industry, for example, is utilizing a multiple basing-point system in which (1) each mill is a base for its local sales area and (2) freight is absorbed on sales into the nearby area of a distant mill to match prices quoted by that mill.

According to a study made by the Subcommittee on Antitrust and Monopoly, United States Senate, the pricing method in steel is as follows:

> Today every production point has been made a base point. . . . Although new bases have been added, f.o.b. base prices are substantially identical for all steel products. . . . Although each producer offers to sell f.o.b. its mills, each producer follows the stated practice of equalizing its freight costs with the freight costs of the nearest producer to a given customer. As will hereinafter be explained more fully, under this practice of pricing, each steel producer can systematically match to the fourth decimal point delivered prices with all of its competitors. . . . The further observation is made that, under the present-day method of pricing, with f.o.b. prices being substantially identical, there is no price competition on an f.o.b. basis so far as a customer is concerned.[19]

An example of the multiple basing-point—or freight-equalization—pricing system used in the steel industry is shown in Figure 32. A and B are steel mills, selling steel at identical base prices. X and Y are buyers. Mills A and B are located 1000 miles apart. Buyer X is located 400 miles from Mill A and 600 miles from Mill B. Buyer Y is 980 miles from Mill A and 20 miles from Mill B.

Under the currently used basing-point system, Mill A will charge buyer X its base price and the actual freight on 400 miles. At the same time, on sales to buyer Y Mill A will charge its base price (or Mill B's base price) plus freight (for 20 miles) from B to Y. Similarly, on sales to buyer X, Mill B will charge its base price (or A's base price) plus freight from Mill A to buyer X, not the actual freight from Mill B to buyer X.

Thus, on sales away from its own local area, Mill A (or Mill B) is quoting a "combination price" which, in effect, is the sum of (1) the base price of

[19] *Administered Prices—Steel*, Report of the Subcommittee on Antitrust and Monopoly, Committee on the Judiciary, 85th Congress, second session, Senate Report 1387, March 13, 1958, p. 117.

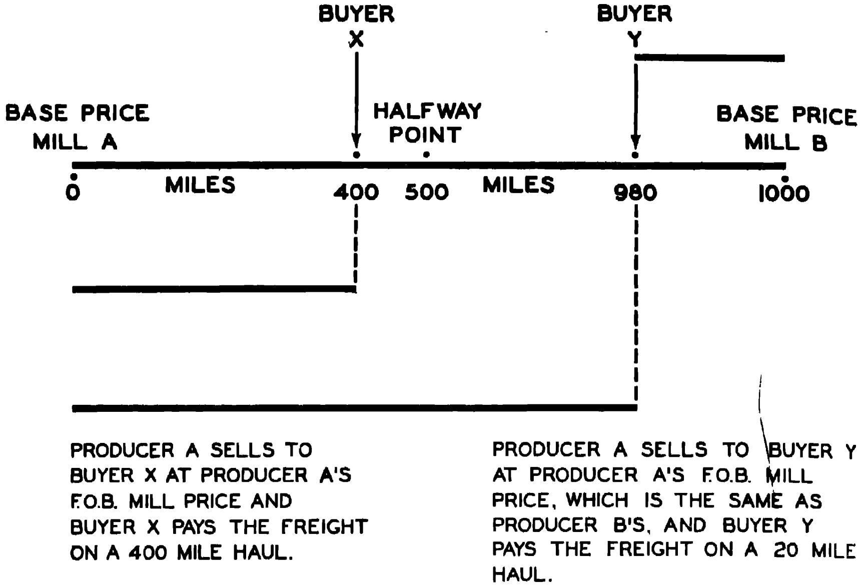

FIGURE 32. An Example of the Multiple Basing-Point System Used Concurrently in the Steel Industry. (Source of data: *Administered Prices—Steel,* Senate Report 1387, 1958, p. 118)

another mill plus (2) the freight from *that* mill to the buyer's destination. This is the essence of basing-point pricing.

At the present time, the Federal Trade Commission is unwilling to apply the decision in the Conduit case, Count II, condemning the concurrent use of basing-point pricing which is shown to have trade-restraining effects.

Since the efforts made by Congress to legalize basing-point pricing, the Commission has indicated that it will not initiate proceedings against the use of delivered-pricing systems *except on clear-cut grounds of conspiracy.* The Pittsburgh Plus, Corn Products, Staley and Conduit (Count II) cases, it will be remembered, were not based upon conspiracy charges. In these cases, the Supreme Court found the basing-point practice itself to be a form and method of monopoly. To the extent that the Commission now accepts the practice, despite the decisions of the Supreme Court, it is widening further the area of exemptions from our antitrust law policy.

Glossary of Terms Frequently Used in Discussions of Basing-Point and Zone-Delivered Prices

Base Mill. A mill whose location is used as a basing point in determining transportation costs. The price charged by a base mill is matched by other mills desiring to sell in the territory served by the base mill; and in such

cases, the various sellers quote the "base price" plus freight from the "base mill" to the customer's location.

Base Price. The price at a given point, called the basing point, which sellers regularly use in quoting delivered prices for a given area. There may be one or several basing points, and each mill of a seller and his locally separate rivals may serve as the basing point for its adjacent area in the particular seller's distribution system. In quoting delivered prices, sellers quote the particular "base price" plus freight from the basing point to the customer's location which gives the lowest combination of price and freight cost. The essence of the basing-point plan is the use of the base price and freight of *some other mill* for pricing purposes.

Basing-Point Formula. A system of pricing in which one or more basing points are used. The delivered price is determined by adding to an established price at a given point, called the basing point, the freight charge —usually rail freight—from such a point to the point of delivery, regardless of the actual origin of shipments or the actual freight cost incurred in the shipment.

Delivered Price. This is the buyer's cost of the goods delivered at the buyer's place of business. It is a collective term for two prices: (1) the net realized price received by the seller at the point of shipment plus (2) the price of transportation—actual, averaged, or fictitious—included in the quotation.

F.O.B. Mill Pricing. The quotation of prices f.o.b. a seller's mill, which are uniform for goods of the same quality, to all buyers in the same trade classification, purchasing at the mill in similar quantities, with delivered costs to various destinations differing by the actual freight, payable by the buyer, from the shipping mill.

Freight Absorption. The excess of the actual freight paid out by the seller in making delivery over the amount of the freight item used in calculating the delivered price to the buyer.

Freight Equalization. The practice of charging a customer the freight cost which he would pay in getting delivery from a nearer supplier, rather than the seller's actual transportation cost. In a plan of freight equalization, every mill is usually regarded as a base; and sellers regularly quote the freight rate *and* the base price of another mill in selling at destinations within the freight territory of that mill.

Mill Net Price (or Return). The amount received by the seller at his mill after deducting actual freight cost, allowed or defrayed by the seller.

National Uniform Delivered Price. The quotation of the same delivered price anywhere in the United States, based upon the inclusion of an average freight item.

Phanton Freight. The excess of the freight item charged the buyer over the freight actually paid out by the seller in making delivery.

Zone-Delivered Price. The quotation of a single delivered price in a given zone, based upon the inclusion of an average freight item. The country is divided into two or more geographical areas or zones, and a uniform delivered price (which usually includes a transportation increment averaged for the zone) is applicable in each zone.

16

Government and Small Business

During the past twenty years, problems of small business have received increasing attention in Congress and the state legislatures, as well as in state and local civic groups.

Two of the most active and constructive Congressional committees are centering their attention on the problems of small business. They are the Select Committee on Small Business, United States Senate, and the Select Committee on Small Business, House of Representatives. A separate Small Business Administration has been permanently established, and numerous agencies—such as the Department of Commerce, Department of Justice, and the Federal Trade Commission—have special units or divisions on small business. Many of the states have established departments to promote and assist small business; and state and local groups of citizens have formed development companies to make loans to small firms.

The large and growing interest in small business reflects, in some degree, the increasing awareness of businessmen that governmental assistance is highly important in business success and survival. In a broader sense, however, the interest in small business comes from a deep belief that if we are to maintain a policy of competition in the American economy, we must look, in the main, to the survival and health of small business. In industries dominated by large business units, it is the small business firms which typically provide price competition. Large business wants "to meet competition"—it does not want to *be* the competition.

Small business enterprises also provide an outlet for new ideas, processes, and services, as conceived by thousands of individuals. There is no centralized board or authority to determine whether or not someone's business idea should be tried. As the House Small Business Committee has stated,

> The possibility of forming new firms gives a large number of individuals an opportunity to back their own ideas with their own resources. It encourages individual initiative. The economy thereby gets the benefit of many new developments which might not pass the scrutiny of a chain of division managers, plant managers, comptrollers, and budget committees in a large corporation. At the same time, new firms provide an outlet for individuals

with ideas and the courage of their convictions whose talents might not be fully employed in a large organization.[1]

Further, the existence of a large number of independent businessmen, having private property and freedom of occupation, provides a fundamental basis for political freedom. Without economic freedom, the lessons of history show, men cannot be free to counter or speak up against arbitrary government or concentrated economic power.

WHAT IS SMALL BUSINESS?

During the twenty-five years or so since the federal government first began to concern itself with the problems of small business, a question frequently asked has been, "What is small business?" There have been different official answers at different times.

Thus, a one-time head of the Smaller War Plants Corporation, the Government's World War II agency for small business, reportedly told committees of Congress he felt that small business could be defined as any firm which was not large enough to maintain lobbyists in Washington! In any case, a variety of programs to assist small business were operated during World War II without any formal definition of "small business" ever having been made.

Actually, of course, "small business" is a relative term, and when we use it at all it is in the context of some business problem that is relative in intensity. Furthermore, much of the justification for government programs of specific assistance to small firms rests on the idea that such assistance amounts to an offset, of a kind, to the advantages conferred upon bigger firms by our legal and institutional framework. Thus it is believed that advantages unrelated to technical efficiency accrue, not just to firms above a certain size, but in proportion to the size of the firm. In any case, it is hardly likely that the business problems confronting any firm become problems of an essentially different nature with the firm's attainment of a few added inches of stature.

Further, since the usual policy of our government is to assist business in general, without distinction as to size of business firm, the question of precise definition of "small business" becomes a question of what the practical program of assistance is to be that is to be limited by the definition of small business.

In the Small Business Act of 1953, Congress defined a small business concern only in broad terms as "one which is independently owned and operated and which is not dominant in its field of operations," and provided for the Small Business Administration to make a more precise definition for each industry or line of trade. Thus the report of the House Committee on

[1] *Problems of Small-Business Financing*, Select Committee on Small Business, House Report 1889, 85th Congress, second session, June 17, 1958, p. 10.

Banking and Currency which accompanied the SBA bill points out that there are several different bases which might be used for classifying firms as to their size—number of employees, volume of sales, assets, and so on. It then concludes with this quite enlightened instruction to the Small Business Administration:

> The determination must take into consideration the general size structure within the industry or commercial group to which the particular concern belongs. For instance, a given volume of sales or number of employees for a concern considered small business in one industrial group, if applied to a concern in another industrial group might well place that concern in the big business category of its particular group. It would be impractical to include in the act a detailed definition of small business because of the variation between business groups. It is for this reason that the act authorizes the Administration to determine within any inquiry the concerns which are to be designated small-business concerns for the purposes of the act.[2]

To date, SBA's efforts at promulgating more precise definitions have produced two widely different definitions. One is applied to the SBA's loan program, the other to its program for assisting small business to obtain a fair share of Government defense and other contracts.

In determining which firms may be eligible to receive assistance under its loan program, the SBA has promulgated definitions which take some account of the fact that a firm of a size which is relatively small in one industry may be relatively large in another. Thus, although individual modifications have subsequently been made, the initial criteria of "small business" in the definition for loan purposes were, as a general rule, calculated to cover the smaller firms which accounted for one-third of the assets or the volume of business done by the industry.

In general, the definitions of "small business" for SBA loan purposes are as follows:

> *Retail and service trade firms:* most of these are small if their annual gross sales are $1,000,000 or less.
>
> *Wholesale firms:* most of these are small if their sales are under $5,000,000.
>
> *Manufacturing firms:* these are small if they employ 250 workers or less, and are "large" if they employ more than 1000 workers. In between 250 and 1000 workers, the definition depends upon the kind of industry.

As to the government's declared policy to distribute an equitable share of its procurement and other contracts to small business, the applicable definition of small business is "any concern which employs 500 or fewer persons, including affiliates."

Use of the "rule of 500" has long been a subject of considerable criticism by committees of Congress and others. Some companies are large in comparison with others, but small in comparison with their multimillion- or

[2] *Small Business Act of 1953,* 83rd Congress, first session, House Report 494, May 28, 1953, p. 3.

billion-dollar competitors. An arbitrary "rule of 500" excludes many small and independent business firms, in particular industries which constitute the competition against the really big companies.

In an effort to strengthen the SBA's hand and make sure that this agency is not being unduly tardy in promulgating an industry-by-industry definition, Congress in 1958 amended the Small Business Act so as to place upon the Small Business Administration a clear statutory responsibility for promulgating such definition. The amended act states: "Where the number of employees is used as one of the criteria in making such definition for any of the purposes of this Act, the maximum number of employees which a small-business concern may have under the definition shall vary from industry to industry to the extent necessary to reflect differing characteristics of such industries and to take proper account of other relevant factors." To date, however, the "rule of 500" still prevails.[3]

It is estimated that there are some 4.6 million active business firms in the United States (see Figure 33). Some 4.4 million of this number can roughly be classified as "small" business. The category of big business is variously defined as (1) the 100 or so largest firms or (2) the 200 or 300 largest firms. Firms other than "small" and "large" are sometimes designated "medium-sized" firms. Some serious students of small business problems have suggested that small business could be defined as any firm other than the 200 or 300 largest corporations of the country.

The concern of government for small business expresses itself, for the most part, in relation to the 300,000 to 400,000 small business firms which compete in various fields with big business. It is these firms, in particular, which are subject to oppressive, coercive, and discriminatory attacks by big business. It is these firms, too, which mainly face the problem of securing a fair share of government procurement and research contracts.

The great bulk of small business, in a general sense, is really "little business"—that is, small firms which consist of lone workers or proprietors with a few employees. Almost all of these small firms are unincorporated. They exist in retail trade, transportation (taxi and truck operators), real estate, insurance, mining, printing, publishing, and the service trades (barber and beauty shops, automobile repair, and so forth). These firms are highly important in our economy, but they do not constitute the main area of attention for special legislation or antitrust law enforcement.

SMALL BUSINESS AND ANTITRUST

In 1959 the House Small Business Committee summarized the central point on governmental concern with respect to small business. It is to insure

[3] In a few instances, mostly on nonmanufacturing trades, modifications of the "rule of 500" have been made.

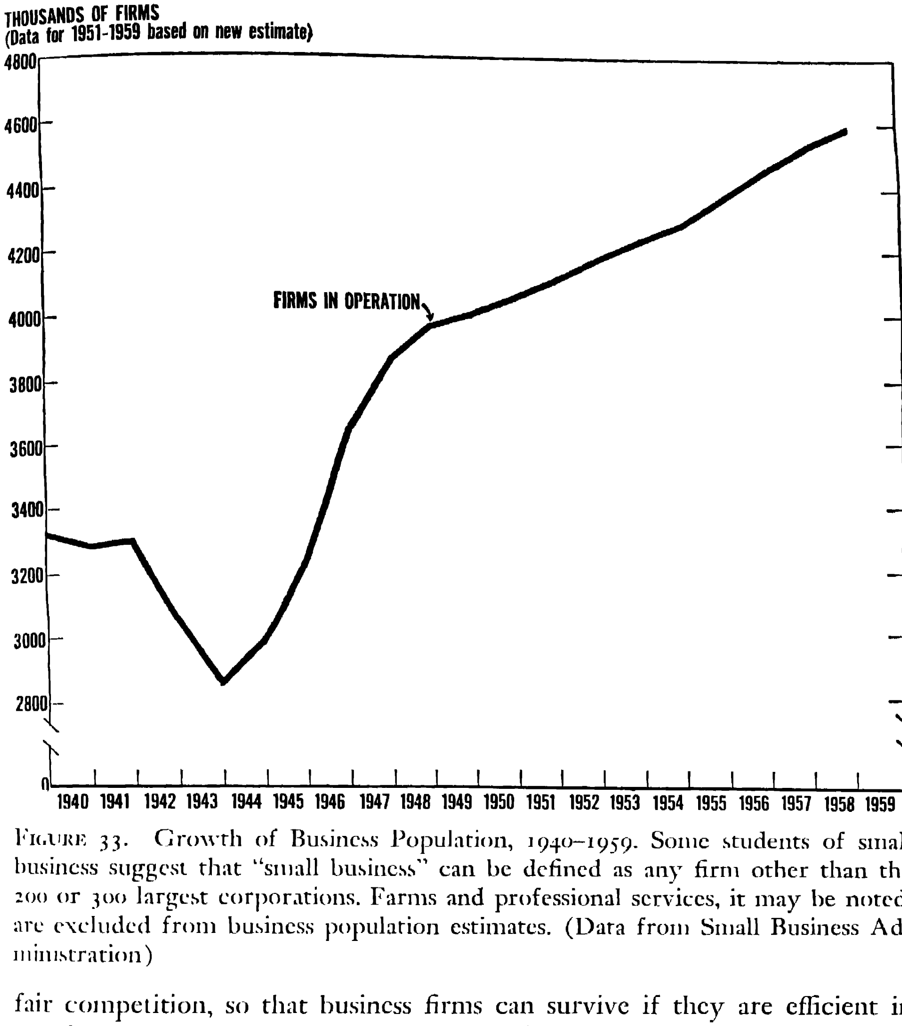

FIGURE 33. Growth of Business Population, 1940–1959. Some students of small business suggest that "small business" can be defined as any firm other than the 200 or 300 largest corporations. Farms and professional services, it may be noted, are excluded from business population estimates. (Data from Small Business Administration)

fair competition, so that business firms can survive if they are efficient in meeting market demands. In the words of the Committee,

> Competitive conditions and business practices make up perhaps the greatest factor in determining the fortunes of any small-business enterprise. This is no retreat from what this committee has said about the importance of adequate financing of small business. Likewise it is no revision of this committee's stated position about the need of relieving small-business firms from undue burdens of taxation and of assuring to small business a fair share of the business flowing from Government procurement. All of these matters are important, but of the greatest importance is the problem of providing small business with the opportunity to compete in an area where competition is fair and where the cards are not stacked against small business by virtue of monopolistic conditions.[4]

[4] *Final Report,* Select Committee on Small Business, 85th Congress, second session, House Report 2718, January 3, 1959, p. 85.

In the legislation establishing the Small Business Administration, Congress declared the following public policy:

> The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect insofar as it is possible the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contacts for supplies and services for the Government be placed with small-business enterprises, and to maintain and strengthen the overall economy of the Nation.[6]

The Small Business Act authorizes the SBA to provide two main types of financial assistance to small firms:

1. Business loans for plant construction and the acquisition of land, equipment, materials, and supplies, for war, defense, or essential civilian production.
2. Disaster loans to business concerns or homeowners, which suffer financial loss from floods, hurricanes, tornadoes, drought, or other catastrophes.

Business loans, the Act provides, may have maturities up to ten years. The maximum loan to any one borrower is $250,000. Direct loans are made when applicants are unable to secure bank financing. Whenever possible, however, the SBA seeks to work with local banks to encourage them to participate in making a portion of the loan. The desire of Congress was that federal financing should supplement—not supplant—private financing.

In the fiscal year 1959, SBA approved 5582 business loans totaling $267,-042,000 (see Table 24). The demand for disaster, drought, and excessive rainfall loans has varied from year to year.

The SBA also assists small business firms with financial counseling. In applying for a loan, a small business concern must submit credit data; and in evaluating these data, SBA officials frequently are able to advise on alternative ways of meeting a problem.

A highly important activity of the SBA consists of helping small business secure a fair share of government contracts for materials, construction, and research and development. In government procurement, a small business firm submitting a low bid may not be given the award on the ground that it is financially or technically unable to perform the work. The SBA is authorized to issue certificates of competency for a particular small business concern. These certificates are binding on a contracting agency. During the

[6] *Small Business Act of 1953,* United States Statutes at Large, 67 Stat. 232.

TABLE 24. Business Loan Operations of the Small Business Administration, 1954–1959

Fiscal Year Ending June 30	Applications Received	Applications Approved	Amount Approved
1954	2,289	473	$27,739,000
1955	3,318	1,172	55,975,000
1956	4,081	1,915	81,977,000
1957	6,864	3,536	159,095,000
1958	7,898	4,014	194,997,000
1959	10,213	5,582	267,042,000

SOURCE Small Business Administration, Washington, D.C.

period of August 1, 1953, to June 30, 1959, the SBA issued 553 certificates to small business firms.

Small business can rarely obtain research and development contracts from the Department of Defense and other contracting agencies because of the more complete research facilities of large business. This situation has added to the difficulties of small business. Small business finds itself doubly handicapped for the future through (1) the concentration of government procurement contracts with big business, particularly in the firms which have performed the research; and (2) the concentration of resulting patents in the hands of big business firms which have developed them under government research contracts (see also Chapter 12, pages 285–286).

The SBA and its regional offices also seek to assist small business by distributing helpful business literature, by arranging seminars for executives of small firms, and by providing information on technical matters, specifications, and product development. In 1958, Wendell Barnes, Administrator of the SBA, commented on the importance of the agency's work in this area. In his words, "Excluding the need for financial assistance and for help in obtaining Government contracts, the most urgent need among many small business concerns is for assistance in improving their management and technical knowhow."[7]

SMALL BUSINESS FINANCING

The common problem of small business firms is that of securing capital. On business financing, the House Small Business Committee has said: "As we have long recognized, the sources of capital for big firms are many and adequate; the sources for small firms, few and scarce."[8] Students of small

[7] *Small Business Administration, 1958*, Hearings Before the Select Committee on Small Business, United States Senate, 85th Congress, second session, March 25, 1958, p. 7.

[8] *Final Report*, Select Committee on Small Business, 84th Congress, second session, House Report 2970, January 3, 1957, p. 29.

business believe that this situation reflects (1) a concentrated control over finance and (2) a lack of financing institutions for small business.[9]

The capital of a business firm consists of (1) equity capital (the net value or sum of the owners) and (2) loan capital. Small business firms usually find it difficult to secure equity capital and, increasingly, to secure long-term loan capital. Large business finances a substantial proportion (nearly half) of its equity capital from retained earnings. Small business is rarely in a position to earn more than a modest return on capital.

Loan capital may be classed as (1) short-term credit—mainly trade credit (debts to other firms for inventories and equipment) and bank credit; and (2) long-term credit—mainly term loans and mortgage loans.[10]

Solutions to the Problem of Small Business Financing

In an effort to meet the problems of small business financing, Congress in 1958 enacted two permanent laws. They are:

1. The Small Business Act, approved July 18, 1958, which establishes a permanent agency *for making short-term and intermediate-term loans* of federal money to small business concerns.
2. The Small Business Investment Act of 1958, approved August 21, 1958, with the purpose of providing *long-term and equity capital* for small business, through private lending facilitated by federal capital sums.

The financial assistance programs of the Small Business Administration were discussed above. The SBA is the one Federal agency which is empowered to make loans of federal money to small business. These loans help to meet the short-term and intermediate-term (up to ten years) capital needs of an important number of small business firms which are unable to secure loans from private capital sources.

The Small Business Investment Act of 1958 was designed by Congress to help meet the problem of small business in securing additional equity capital

[9] In 1913 a special Congressional committee reported that leaders in finance had secured a "money trust." The committee defined the "money trust" as an established and well-defined identity and community of interest between a few leaders of finance which has resulted in a vast and growing concentration of control of money and credit in the hands of a comparatively few men (*Report of the Committee to Investigate the Concentration of Control of Money and Credit*, 62nd Congress, third session, House Report 1593, 1913, p. 130). In 1946 the Department of Justice reported: "Industry's silence on banker influence is mute testimony to its strength, not a sign of its absence. As long as they are dependent on a particular banking group for their financing, they dare not protest against such influence, even if it means that a particular company does less business than it would if it were free to compete more vigorously" (*United States Versus Economic Concentration and Monopoly*, Staff Report of the Monopoly Subcommittee of the Committee on Small Business, House of Representatives, 1946, p. 239).

[10] For an excellent survey of small business financing, see *Problems of Small Business Financing*, Select Committee on Small Business, 85th Congress, second session, House Report 1889, June 17, 1958.

and long-term loan capital. The law is administered by the Small Business Administration. It establishes a program for providing equity capital and long-term capital through (1) privately owned and operated small-business investment companies and (2) state and local development companies.

Small business investment companies may be created by ten or more stockholders under the incorporation laws of a state. The paid-in capital and surplus must be not less than $300,000. The SBA, however, is authorized to loan each investment company up to $150,000 for part of its paid-in capital and surplus. Thus, to establish an investment company ten person need only to invest an average sum of $15,000 each. In addition to the loan of $150,000, the SBA is authorized to lend a small business investment company additional funds up to one-half of its paid-in capital and surplus.

Small business investment companies operate by providing equity-type capital to small business concerns in exchange for convertible debentures on conditions approved by the SBA. These securities give the investment company the privilege of converting such debentures into the common stock of the small business firm. The investment company may also make long-term loans to small business concerns—up to twenty years with provision for an additional ten years for liquidation purposes.

The Small Business Investment Act of 1958 provides also for the making of loans to state and local development corporations. State and local development companies are entities formed by state or local civic-minded groups for the purpose of assisting small business at the state or local level. Loans made to these companies are utilized by them in making loans to small business firms.

A further provision of the Small Business Investment Act authorizes the SBA to make grants of money to any state government, state development corporation, college, or university for studies on small business problems. Only one grant can be made in any state in any one year, and the amount may not exceed $40,000.

SMALL BUSINESS AND GOVERNMENT PROCUREMENT

Congressional committees on small business devote substantial effort to the problems of small business in securing an equitable share of government contracts. Each year federal procurement agencies award contracts to private firms for supplies, services, and construction work amounting to around 20 billion dollars. The great bulk of these awards are made by the Department of Defense.

Congress has repeatedly passed laws declaring that small business firms shall be given opportunity to secure a fair share of government contracts. These laws, however, have not been effectively implemented. The Department of Defense, moreover, has shown little sympathy for the declared policy of Congress. Military procurement officers prefer to deal with big

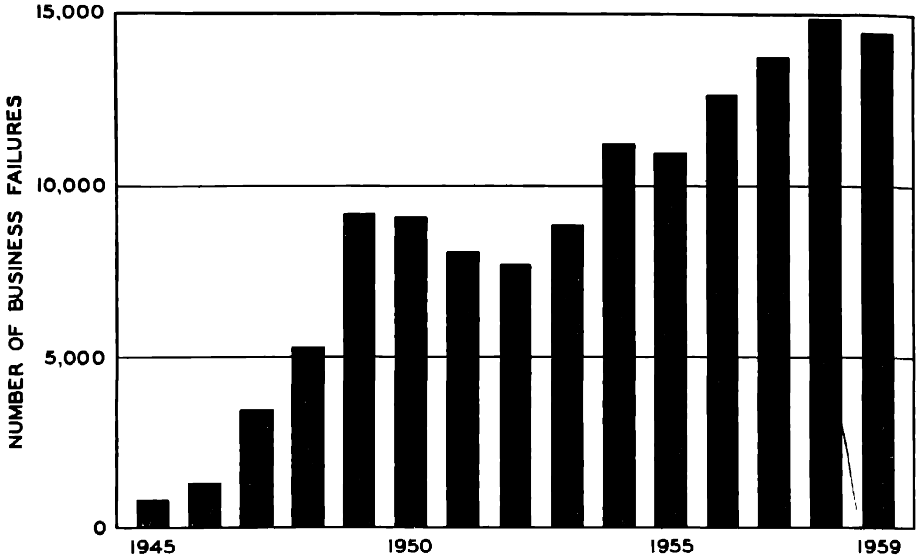

FIGURE 34. Number of Business Failures, 1945–1960. (Source of data: Dun and Bradstreet, Inc.)

business firms. It takes less time and effort to place a contract with one or two firms rather than with numerous suppliers. Responsibility for delivery, moreover, can be centralized.

The attitude of the Department of Defense is that the place for small business in government procurement lies in securing subcontracts with big business, not in getting prime contracts. With respect to this point of view, the House Small Business Committee has said: "Under such system of procurement, the small-business segment of our industry will become the unwanted stepchild of big business and become completely subservient to major companies."[11]

The share of the Defense Department awards going to big business has been increasing each year. From July 1950 to December 1957, the 100 largest corporations participating in the program secured 63 percent of the total. In the fiscal year of 1957, these 100 companies secured 68.4 percent of the total; and in fiscal 1958, their share was increased to 74.2 percent. In the fiscal year 1959, small business, as defined by the SBA, received 17.2 percent of all military contracts.

Government procurement is normally made by a call for bids with the award being given to the lowest bidder. A special exception, however, has been made to this rule. During a period of national emergency (which was declared by the President to exist in 1941), the Department of Defense is privileged to enter into contracts by negotiation, without an advertised call

[11] *Final Report*, Select Committee on Small Business, 84th Congress, second session, House Report 2970, January 3, 1957, p. 93.

for bids.[12] As of 1960, the United States continues to be in a declared state of national emergency, and it does not appear that this condition will be changed in the foreseeable future.

The Department of Defense has extensively utilized its authority to purchase supplies and equipment by negotiation, rather than by a call for bids. In this way, it can select the supplies it desires. It can tell the supplier in a general way, moreover, what is desired, and then let the supplier develop the product. During the fiscal year 1959, some 80.1 percent of all military buying was done on a negotiated, noncompetitive basis, without a call for bids.

Small business firms are in a position to bid on specific contracts, with the details specified in advance. It is then that estimates of cost can be made and competitive bids submitted. When the military procurement officers, however, grant contracts upon the basis of conferences with engineering staffs and the submission of general plans, it is only big business which has the capital and personnel to go to Washington and participate.

The military finds ease and convenience in negotiated buying. It appears unlikely that competitive bidding will soon again be extensively used in defense procurement or that small business will secure a more equitable share of defense contracts.

SMALL BUSINESS AND TAXES

Since World War II, it has been well established, large business firms have financed much of their expansion through retained earnings. Small business firms, however, Congressional hearings show, have not shared fully in the post-war prosperity and have not been able to retain sufficient earnings to grow with the economy. This fact has led a number of Congressional committees to make studies on the tax problems of small business which bear on the ability of small firms to retain earnings for business expansion. In the words of the House Small Business Committee, "The thought was expressed on the record of the committee hearings that one of the greatest boons which could be given to small business for the expansion of industry would be to permit small business to accumulate and retain earnings out of which it could finance needed modernization and expansion."[13]

Most small business firms are unincorporated, and the owners must pay individual income tax rates on the business profits. These rates are high and steeply progressive. Small corporations, also, usually operate in highly competitive markets and have little or no discretionary control over price. They are thus in an unfavorable position for passing corporate income tax burdens on to consumers or back to suppliers. Large, multiplant companies, on the

[12] *U.S. Code,* Title 10, par. 2304.

[13] *Final Report,* Select Committee on Small Business, 85th Congress, second session, House Report 2718, January 3, 1959, p. 50.

other hand, have greater freedom from competitive pressures and are frequently able to pass a portion of their corporate income tax burden on to consumers in higher prices or to suppliers in lower buying prices. The impact of the federal tax structure, therefore, it is reasoned by spokesmen for small business, is to take from small firms funds which are available to big business for business expansion.

Many bills have been introduced in Congress to provide small business with tax relief; and in recent sessions of Congress, various small business tax adjustments have been enacted. A number of these measures are highly technical, and some are modified from session to session. All are reported each year in the annual reports of the House and Senate Small Business Committees, and interested students will be able to secure up-to-date compilations from these sources.

SMALL BUSINESS NEEDS "A FAIR FIELD AND NO FAVOR"

The concern of government for the survival of small business is fully in accord with its function to maintain the essential conditions of competition. At the present time, it is especially important for government to encourage and protect small business, for the burden of providing price competition largely rests on small firms which act independently in selling their products.

Experience has shown that small business does not need subsidies or special favors in order to prosper. It does, however, need an equal chance to obtain supplies and materials, without being restrained—by refusals to sell—in competition with those who are able to buy. Small business also needs the opportunity to survive without being crippled by price discrimination—by local price cutting as well as by the payment of higher cost-prices than those paid by others.

Congressional efforts to curb price discrimination "where the effect may be substantially to lessen competition" have been, for the time being, frustrated by the powerful opposition of big business representatives. Big business wants to retain the practice of being able to cut delivered prices in particular local areas, while maintaining them elsewhere, to injure, weaken, or discipline a concern which shows price independence. It also wants to be able to use its financial power to secure lower cost-prices from suppliers than are paid by small competitors.

In recent years, Congress has moved forward to assist small business largely by (1) financial assistance (loan) programs and (2) the granting of certain tax benefits. Constructive legislation in these areas rather than in antitrust has been possible because the loan and tax measures do not mean a trimming of favors enjoyed by big business. It has not been necessary for Congress to "step on somebody's toes."

In large measure, remedies for the problems of small business are to be found in programs for strengthening the antitrust laws, for providing

additional sources of capital, and for increasing its share of procurement contracts. In all of these programs, no subsidies are involved. Government is trying only to balance the scales.

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Federal Regulation of Corporations and Capital Markets

The growth of the American economy has been marked by the rise of the modern corporation as the principal instrument for conducting business activity. The creation of these supercorporations, as well as the thousands of underlying corporations, both of which use and obtain capital from millions of investors, has also brought into being a complex system of securities markets, brokers, dealers, investment bankers, and investment companies. Increasingly, management in the large corporations has become separated from ownership. In many situations, moreover, management has found itself in a position to handle vast amounts of other people's capital with a responsibility for this stewardship only to itself.

Until the time of the great depression, legal controls for regulating corporations and the capital markets were mainly the state corporation laws, state security laws, and certain common-law principles used by the courts. These mechanisms proved themselves to be quite inadequate in preventing fraud, financial manipulation, and the abuse of corporate power. Over the years, moreover, the states had competed with one another in granting liberal corporate charters in order to build a source of revenue from corporate fees. Little or no control consequently was exercised over corporations in their use of investors' money.

The state security laws—called "blue-sky" laws because it was believed that some promoters would even sell shares in the blue sky—varied widely in their effectiveness. Generally, the state laws provided that new security issues should be "fair, just, and equitable." Economic standards for judgment, however, were not provided. The state laws, moreover, did not provide a means for regulating interstate transactions in securities.

GREAT DEBACLE OF 1929 ACCENTUATES DEMAND FOR REFORM

The stock-market crash of 1929 and the failure of such large corporations as Kreuger and Toll, the International Match Company, and the Insull utility combination, causing a loss of millions to thousands of stockholders, brought to light many serious abuses and excesses in corporate activity. The broad powers conferred on directors by corporate charters gave them almost unlimited and absolute power over the issuance of securities, the exchange of securities, the payment of dividends, the making of reports to stockholders, the conduct of reorganizations, and the acquisition and control of other corporations. As a result of these powers of control and the separation of management from ownership, it was found that in many cases officers and directors were operating corporations for speculative and manipulative gains and for their own personal benefit, without taking a "long view" toward the welfare of the business or the public.

The corporate abuses and excesses revealed themselves most vividly in the utility field. The period of 1920–1929, we have seen, was one in which the formation of public utility mergers was especially extensive. Centralized financial control in the principal branches of industry—such as steel, the nonferrous metals, oil, and sugar—had already taken place. The dynamic, currently active field for speculative and monopolistic merger activity was the utilities.

Investigations by the Federal Trade Commission and Congressional committees, in particular, revealed the existence of a large variety and number of unsound corporate practices, especially in the management of public utility *holding* companies.[1] The evidence secured in various investigations showed that (1) securities were often issued in excess of the value of the assets held by a corporation; (2) many corporations engaged in stock financing far beyond any legitimate foreseeable business need and plowed their extra cash back into the stock market through loans to brokers; (3) dividends were sometimes paid out of capital when earnings were insufficient; (4) securities were issued and sold to the public without revealing significant information and with an actual misrepresentation of earnings and the uses to which the funds were to be applied; (5) prices of securities on the stock exchanges were frequently manipulated in order to induce public buying or selling; (6) deceptive and unsound methods of accounting were

[1] Important investigations were: Hearings Before the Committee on Interstate and Foreign Commerce on H.R. 4314, *Federal Securities Act*, 73rd Congress, first session, 1933; Hearings Before the Committee on Banking and Currency on S.R. 84, *Stock Exchange Practices*, 72nd Congress, 1932, six parts, and 73rd Congress, 1933, twenty parts; and Report of the Federal Trade Commission to the Senate of the United States, pursuant to Senate Res. No. 83, *Utility Corporations*, 70th Congress, first session, 1928. In Serial Set Vols. 8855, 8856, 8857, 8858.

often used in recording assets, liabilities, and earnings; (7) holding companies frequently charged their affiliates excessive fees for services rendered; and (8) capital accounts were sometimes "loaded" in order to establish a base for excessive rates.

THE SECURITIES ACT OF 1933

The problems of regulating the sale of corporate securities had been under review by Congress for many years prior to 1929. Following the collapse of the stock market, public opinion speeded the adoption of pending legislation in the Securities Act of 1933. The Securities Act was originally administered by the Federal Trade Commission. With the enactment of the Securities Exchange Act in 1934, however, the administration of both of these laws was placed in the hands of the Securities and Exchange Commission. This agency, a bipartisan commission, was created in 1934 and is composed of five members appointed for terms of five years.

The Securities Act of 1933 is sometimes called "The Truth in Securities Act." As contrasted to many state securities laws (so-called "blue sky" laws), the purpose of the federal act is not to have the Commission pass on the merits of the securities being offered, but instead to require a full disclosure of all material facts with respect to the issuance of *new* securities before they are publicly offered for sale. The idea is to provide an investor with information for making an intelligent judgment of a security before he buys it. The Act places a burden on the *seller* to disclose pertinent information on the securities to be sold. Its viewpoint is "let the seller beware." The underlying principle is that the light of publicity will serve to deter misconduct and assist the investor in making an informed investment decision.

The Securities Act applies to securities sold by any means or instruments of transportation or communication in interstate commerce or of the mails. The inclusion of "*communication* in interstate commerce" vests jurisdiction in the Commission to control unsolicited, high-pressure telephone calls urging the immediate purchase of certain securities—the so-called "boiler room" operations.

Before securities subject to the act can be sold, the issuing company must file a registration statement with the Securities and Exchange Commission giving all the material facts with respect to the corporation, its organization, the nature of its business, the purposes for which the money is to be used, the compensation of officers, the profit and loss and balance sheet records, and other relevant data. It is also required that a digest of the registration statement be given by means of a prospectus to all persons to whom the securities are offered. Certain securities and transactions are exempted—namely (1) securities of governmental bodies, banks, charitable organizations, railroads, and building and loan associations; (2) any transactions by a person other than an issuer, underwriter, or dealer, or not involv-

ing a public offering; and (3) offerings restricted exclusively to residents of the state of incorporation where the company is doing business. As authorized by the Act, the Commission has also seen fit to provide exemptive rules under which information to be furnished is reduced and streamlined for small offerings.

The Securities Act of 1933 has a dual objective, namely (1) to expedite the flow of capital into legitimate business enterprises and (2) to prevent fraud in the sale of securities. The antifraud provisions of the Act make violative not only misrepresentations, but also the omission of material facts.

The Securities Act of 1933 contains three sanctions for securing obedience to the law. First, the SEC is given authority to prevent by administrative proceedings and injunction the sale of securities because of false material statements or failure to furnish material information. Secondly, civil liability is imposed on those responsible for the flotation of an issue for false, untrue, or inadequate material representations. Thirdly, criminal liability is provided for any willful violation of the Act. Persons convicted of fraudulent acts are subject to private suits for damages, as well as to governmental suits for fines and prison sentences. During the period 1934–1960, more than 1300 persons were convicted in criminal cases.

THE SECURITIES EXCHANGE ACT OF 1934

The purposes of the Securities Exchange Act of 1934 are (1) to eliminate fraud, manipulation, and other abuses in the trading of securities, both on the organized exchanges and in the over-the-counter markets; (2) to make available to the public information regarding the condition of corporations whose securities are listed on any national securities exchange; and (3) to regulate the use of the nation's credit in securities trading. Each securities exchange in the United States is required to register with the Securities and Exchange Commission, as are all brokers and dealers using the mails or other instrumentalities of interstate commerce in the sale of securities. The records of the exchanges, brokers, and dealers are also inspected periodically in order to determine whether or not the registrants are complying with the law. If violations are found to exist, the Commission is empowered to revoke a firm's registration as a broker-dealer.[2]

[2] The national securities exchanges registered with the SEC consist of the following: (1) Boston Stock Exchange; (2) Chicago Board of Trade; (3) Cincinnati Stock Exchange; (4) Detroit Stock Exchange, (5) Los Angeles Stock Exchange; (6) Midwest Stock Exchange; (7) New Orleans Stock Exchange; (8) American Stock Exchange; (9) New York Stock Exchange; (10) Philadelphia-Baltimore Stock Exchange; (11) Pittsburgh Stock Exchange; (12) Salt Lake Stock Exchange; (13) San Francisco Mining Exchange; (14) San Francisco Stock Exchange; (15) Spokane Stock Exchange; and (16) Washington Stock Exchange. An "exchange" is an auction-floor market. Over-the-counter markets, by contrast, consist of dealers and brokers conducting transactions in their places of business.

Main Objective of the Act of 1934

In regulating the trading of securities, the law seeks to maintain free and open markets, on the exchanges as well as in the over-the-counter markets. Prices of securities, the law affirms, should be determined by the free operation of the forces of demand and supply, without fraud, manipulation, or private control. Investment firms selling their own stock to customers on a dealer basis are required to sell at a price which is reasonably related to the going price.

In order to provide investors with *current* information on corporate securities, the act of 1934 requires all corporations whose securities are traded on any of the national exchanges to register their securities with the Commission and file periodic reports of their business activity. All corporation reports secured by the Commission under the law are available for public inspection.

Trading by Insiders

A further provision of the Act (Section 16) requires influential stockholders (persons owning more than 10 per cent of any class of a security), directors, and officers of corporations with securities registered on a national exchange to file reports of transactions in the securities of their companies. A similar provision is contained in the Public Utility Holding Company Act of 1935 and the Investment Act of 1940. The reports must be filed with the Commission once a month. If persons covered by the section ("insiders") make a short-swing profit, either buying and selling or selling and buying, within a six-month period, they may be required by the corporation or by a stockholder to turn their profits back to the corporation.

Upon the basis of the fraud provisions of the Act, insiders buying stock from or selling stock to a person who is not an insider, and possessing information about the value of the stock not known to the noninsider, may be in violation of the Act and subject to a suit for collection of damages.

The primary purpose of Section 16 was to destroy "vicious practices unearthed at the hearings" which revealed "the flagrant betrayal of their fiduciary duties by directors and officers." Many millions of dollars, it was found, were frequently made by insiders who had advance information of significant corporate activity—such as the increase or passing of dividends. In order to assist investors in learning whether insiders are buying or selling, the Commission publishes a monthly summary of transactions by such persons. Interested students may secure this publication by writing to the Commission.

As a means of regulating speculation in securities, the Federal Reserve Board is given authority to prescribe rules and regulations on the amount of credit which can be extended by brokers or banks to those buying securities which are registered on a national exchange. These rules are enforced

by the SEC. The Securities and Exchange Commission itself is empowered to regulate the borrowing of brokers, dealers, and members of the security exchanges with respect to the use of customers' securities.

The national exchanges provide an auction market for some 3000 corporate stocks. By way of contrast, the over-the-counter markets (private dealers and brokers) are an informal market for some 4500 actively traded corporate stocks. Corporations whose securities are traded in the over-the-counter markets are not subject to the rules (1) requiring that significant financial information be made available to the SEC and the public, (2) curbing the abuses of speculative dealing by corporate insiders, and (3) requiring compliance with proxy regulations.

Regulation of the Proxy System

Under Section 14 (a) of the Securities Exchange Act of 1934 the Commission is given authority to regulate proxy solicitation with respect to securities listed on national securities exchanges. Authority over proxy solicitation is likewise granted to the Commission by Section 12 (a) of the Public Utility Holding Company Act of 1935 and Section 20 (a) of the Investment Company Act of 1940 in connection with the securities of companies subject to those acts. The basic idea of Congress in giving these powers to the Commission was that corporate management is a stewardship which should be directed by the informed judgment of the stockholders. In principle, the stockholders have the right to prescribe the rules by which the management shall operate the business. They also have the power to change the management. In fact, however, with the formation of large financial corporations and with the diffusion of ownership among many scattered investors, stockholder control has largely come to be replaced by management control. Many stockholder meetings are a mere formality at which the management votes the proxies sent in by absentee owners. A proxy, it may be noted, is a document giving authority to act for another.

In exercising its powers over proxy solicitation, the Commission has sought to give stockholders an effective opportunity to participate in the control of their corporations (see Figure 35). Management is required to include in the proxy statement *all* of the proposals which it intends to present at the annual meeting and to give the stockholders an opportunity to vote on these proposals. Information submitted to the stockholders must be adequate and truthful, and a disclosure must be made of the remuneration of officers and directors. Stockholders themselves are privileged to submit proposals in the proxy material and to prepare a 100-word statement on such proposals for inclusion in the proxy material submitted by management.

The belief of the Securities and Exchange Commission is that the proxy system can be modified to provide an annual meeting substantially equivalent to a meeting of the stockholders in person. In the words of Commissioner Robert H. O'Brien,

P R O X Y

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

The undersigned hereby appoints Cleo F. Craig, John W. Davis, Arthur W. Page, Elihu Root, Jr. and Samuel A. Welldon, and each or any of them, attorneys, with the powers the undersigned would possess if personally present, to vote all stock of the undersigned in American Telephone and Telegraph Company at the annual meeting of its stockholders to be held on . . . ., and at any adjournment thereof, upon the election of Directors and upon other matters properly coming before the meeting. Without otherwise limiting the generality hereof, said attorneys are directed to vote on the proposals set forth in the accompanying proxy statement as follows:

On proposals by certain stockholders.
The Directors favor votes AGAINST these proposals.

	FOR	AGAINST
1. Restricting officers' pensions	☐	☐
2. Regional meetings	☐	☐

On proposal by the Directors.
The Directors favor votes FOR this proposal.

	FOR	AGAINST
3. Lybrand, Ross Bros. & Montgomery as Auditors	☐	☐

Unless a contrary direction is indicated this proxy when returned properly signed will be voted AGAINST proposals 1 and 2 and FOR proposal 3.

Dated 19

____
(*Signature of Stockholder*)

FIGURE 35. A Typical Proxy Card. It gives management (1) authority to elect a board of directors consisting of the particular nominees described in a statement sent with the proxy and (2) discretionary authority to vote a stockholder's stock in accordance with the management's own judgment on matters presented at the meeting concerning which the management is not aware at the time the solicitation is made. The SEC is seeking to provide stockholders with a more active participation in corporate control on the principle that management is a stewardship which should be directed by the informed judgment of the stockholders. Under SEC rules, owners of listed securities may now submit proposals in the proxy material sent to all stockholders by the management and request a yes or no vote. If the management opposes the proposal, a 100-word statement in favor of the proposal may also be presented for inclusion in the proxy material. The right to have proposals included in the management's proxy statement does not apply to elections to office.

> I know that the old-fashioned meeting cannot be revived. Admittedly, that is impossible. It is not impossible, however, to utilize the proxy machine to approximate the conditions of the old-fashioned meeting. The proxy machine can be used to afford to the stockholders a means of communicating with each other, to give them the opportunity to submit proposals to their fellow stockholders, and to secure the collective judgment of those stockholders on their proposals. . . . Our experience shows that stockholders are eager to avail themselves of this privilege. They are beginning to feel that they have a part to play and they are willing to undertake it.[3]

The promulgation of proxy rules by the Commission has helped in some degree to revitalize stockholder participation in corporate affairs. Much additional work along this line, however, needs to be done. Many believe, for example, that it would be desirable to require all corporations with listed securities to solicit proxies. Almost one-fourth of the registered corporations do not solicit proxies. In many cases, this reflects a desire of directors to perpetuate themselves in office by avoiding action to secure a quorum at scheduled annual meetings. Companies with securities traded over the counter, moreover, are not subject at all to the proxy rules of the Commission. It has been proposed, further, that the Commission formulate standards for corporations to use in preparing their annual reports. At the present time, the reports of corporations to their stockholders vary greatly in the information they give, in the clarity of their expression, and in the accuracy of the disclosures they make.

A problem arises also in the election of the management. Each year the stockholders are presented with a single slate of nominees prepared by the management itself. If the stockholders vote, the management wins; and if they do not bother to vote, the same management holds over for another year. It has been suggested that stockholders should be permitted to make their own nominations, and that these nominations should be included in the soliciting material sent out to the security holders by the management. The Commission has considered this proposal but has not adopted it. In the Commission's opinion, the proposal is one which should be adopted and made effective by the corporate managements themselves.

Additional Regulations to Protect Investors

As a result of the many abuses which were found to exist in the organization and operation of investment trusts and in the conduct of investment

[3] Robert H. O'Brien, "Stockholders and Corporate Management," an address made before the Conference Board, New York City, January 21, 1943, p. 2 (Securities and Exchange Commission [Washington, 1943]). Several agencies have come into being to represent stockholders at annual meetings. They include the Gilbert Brothers, 1165 Park Avenue, New York City, who attend numerous meetings and press for greater corporate democracy. The Gilberts are willing to vote the proxies of other stockholders issued by companies in which they are stockholders. The Federation of Women Shareholders in American Business, Inc., New York City, likewise represents stockholders' interests and seeks to place qualified women on boards of directors.

counseling firms, Congress enacted the Investment Company Act of 1940 and the Investment Advisers Act of 1940. This legislation requires all investment trust companies to register with the Securities and Exchange Commission and prescribes rules for their conduct. Investment advisers are also required to register with the Commission, and prohibitions are placed on the use of any scheme, device, or practice to defraud or mislead a client. The Commission is empowered to enforce the provisions of the laws and to make such rules and regulations as are necessary to carry out the purposes of the legislation.

FEDERAL REGULATION OF PUBLIC UTILITY CORPORATIONS TO PROTECT INVESTORS AND CONSUMERS

The many abuses which were found to exist in the operation of public utility holding companies led to a demand for special regulatory legislation in the electric and natural gas utility fields. This demand came not only from investors who had lost millions of dollars in the failure of utility enterprises during the early part of the depression, but also from consumers who were being forced to pay unreasonable rates as a result of the controls exercised by holding companies over operating subsidiaries. Since a large part of the utility operations was carried on across state lines, it was impossible for the state commissions to exercise any sort of effective control. The speculative collapse of the Insull group of utility holding companies in 1932, in particular, emphasized the need for federal control, and the question of public utility regulation became a major issue in the presidential election of that year. Finally, in 1935, after a vigorous struggle in both houses of Congress, the sponsors of federal control secured the enactment of the Public Utility Holding Company Act.

In making a request for the enactment of the Public Utility Bill, President Roosevelt declared that it was hoped that in five years arrangements could be made to dissolve all utility holding companies which could not justify themselves as being necessary for the effective functioning of the operating companies which they controlled. Holding companies, he continued, ought not to be permitted to profit from dealings with subsidiary companies when these companies have no chance to bargain with others to secure a better price. "If we could remake our financial history in the light of experience," he stated, "certainly we would have none of this holding company business. It is a device which does not belong to our American traditions of law and business. . . . It is a corporate invention which can give a few corporate insiders unwarranted and intolerable powers over other people's money. In its destruction of local control and its substitution of absentee management, it has built up in the public utility field what has justly been called a system of private socialism which is inimical to the welfare of a free people."[4]

[4] *The Public Papers and Addresses of Franklin D. Roosevelt* (New York, 1938), Vol. 4, pp. 100–101.

Public Utility Holding Company Act of 1935

The Holding Company Act was approved by Congress on August 26, 1935, after passing the Senate with a margin of only one vote. Utility company executives spent thousands of dollars in an effort to defeat the bill, and many of the proposals for control had to be compromised in order to secure adoption. Even so, the act stands as one of the most significant forms of control which has ever been passed by Congress. Its principal provisions are as follows:

1. All interstate public utility *holding company* systems engaged in the electric utility business or in the retail distribution of natural or manufactured gas must register with the Securities and Exchange Commission. They must also file certain basic data and submit annually such information as the Commission deems necessary to effectuate the purposes of the act. A holding company is defined by the act as a corporation which holds 10 per cent or more of the voting stock of a public utility company or another holding company.

2. In general, all gas and electric holding companies must be limited "to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary . . . to the operation of such integrated public-utility system." Under certain conditions, it is possible for the Commission to permit a holding company to control more than one integrated system. A single integrated public utility system is considered to be one or more units of generating plants, transmission lines, and distributing facilities which may be economically operated as a single interconnected system in a single area or region, in one or more states, and not so large as to impair efficiency in management or effectiveness in regulation.

3. The act provides that all holding companies above the "second degree" must be dissolved, unless an exception is made by the Commission. A corporation which controls an operating company (by owning and voting some or all of its stock) is known as a "first degree" holding company; and a corporation controlling the first holding company, in turn, is called a "second degree" holding company. The purpose of prohibiting more than two tiers of holding companies is to simplify the holding company system and to redistribute voting power among security holders on a fair and equitable basis.

4. The approval of the Commission is required for the issuance of new securities and for the acquisition of additional utility assets or securities. The Commission has authority to fix the "fair purchase price" for any securities or assets which are acquired, and to deny any acquisition which does not "serve the public interest by tending towards the economical and efficient development of an integrated public-utility system."

5. The financial and commercial relations of holding companies and their subsidiaries are brought within the control of the Commission. All registered holding companies must report their service, sales, and construction contracts for Commission approval.

6. Interlocking directorates with banking companies are prohibited, and intercompany borrowing is made illegal.

7. The Commission is empowered to require holding companies to use uniform accounting systems and to file periodic reports. It is also authorized to formulate such rules and regulations for the control of utility holding companies as it may deem necessary to carry out the purposes of the act.

8. Finally, it is provided that it shall be unlawful for any holding company or its subsidiaries to make contributions to any political party or candidate in federal, state, or local campaigns, or to engage in lobbying activities without specific approval by the Commission.

The Securities and Exchange Commission has made noteworthy progress in carrying out the purposes of the Holding Company Act. During the fiscal year 1947, holding companies were required to divest themselves of thirty-one subsidiaries with assets of $1,978,000,000. From December 1, 1935, to June 30, 1951, 753 utility companies with assets of $10,311,000,000 were divested from holding company systems. Most of these companies are now independent operating utilities. Most of them, moreover, are now fully subject to state control. In general, divestments are carried out by the sale of securities in the open markets, by outright distributions, or by the issuance of purchase warrants to stockholders of the parent company. Notable progress has also been made in simplifying corporate structures and in redistributing voting power among the various security holders.

In regulating the sale of new securities, the Commission has adopted the rule (with certain exceptions) that securities issued by companies under the Holding Company Act shall be sold by competitive bidding. Competitive bidding means a public offering of securities with sealed bids opened in the presence of bidders and with sale to the highest bidder. This wholesome rule was introduced to provide "arm's-length bargaining" in the sale of securities—that is, to insure that an issuing company will be free to receive bids from various buyers as well as from its regular investment banker.

The provisions of the Holding Company Act do not call for the complete elimination of all holding companies in the public utility field. Any holding company which can qualify as a "single integrated system" is permitted to continue as a regional enterprise. All such systems remain subject to regulation by the Securities and Exchange Commission with respect to financing, intercompany transactions, service charges, and other activities, as noted above. The Commission estimates that about twenty regional holding company systems with assets of some $7 billion will be permanently subject to its jurisdiction.

Provision of Additional Protection for Investors and Consumers in the Public Utility Field

The Public Utility Act of 1935 sought primarily to control the abuses which were found to exist in the electric and gas utilities as a consequence

of the holding company form of organization. Title II of the Utility Act of 1935 is the Federal Power Act of 1935. This act gave the Federal Power Commission authority to regulate mergers, the issuance and acquisition of securities, and interstate rates and service, in the electric utility field. The jurisdiction of the Federal Power Commission over those matters is limited to the *operating* company level. Supervision over the *holding company* systems, as we have seen, is vested in the Securities and Exchange Commission.

Further protection to consumers in the utility field was provided by Congress in 1938 with the enactment of the Natural Gas Act. This act gives the Federal Power Commission authority over the rates and service of companies transporting natural gas in interstate commerce and selling it at wholesale in interstate commerce. The Natural Gas Act does not provide authority to regulate security issues, but it does require that certificates of public convenience and necessity be secured before the construction of new interstate natural gas facilities is undertaken.

Present Area of Conflict in Public Policy

We have seen that thus far Congress has provided a considerable measure of regulation over corporations in the public utility field for the protection of investors and consumers. At the present time, major issues in public policy are proposals (1) to make corporate managers responsible to the corporate owners and (2) to extend public regulation over large corporations *in industry and commerce* to protect the interests of small business and consumers, generally.

The lack of responsibility of many corporate officials to their stockholders is still a problem which remains unsolved. Professor William Z. Ripley, a long-time student of business corporations, has declared: "There is nothing yet in the Securities, Securities Exchange, or Utility Holding Acts covering the relationship between the *owners* and the *management* which holds the latter to an accountability for its administration of its trust, except as provided by the charters under which those managements exercise those powers. And those charters are not derived from the federal government but from the different states. So that these responsibilities as between the owners and the tier of management are in a condition resembling nothing but chaos."[5] The principal charter-granting states, as we have seen, have done little to provide public regulation, and as a consequence all sorts of charter provisions have been established which give directors and officials many powers of control without specific responsibility to the corporate owners.

In a summary of the TNEC findings with respect to the relations between corporate managers and their stockholders, Dr. David Lynch states that "apparently there has developed a code which permits the exploitation of

[5] *Federal Licensing of Corporations*, Hearings Before a Subcommittee of the Committee on the Judiciary on S. 10, 75th Congress, first session, 1937, Part 3, pp. 270–271. Italics supplied.

corporate stewardship for personal gain. The ordinary requirements of integrity and trust usually demanded of lesser men, and in little things, too frequently have been set aside when dealing with big things involving large sums." [6] It is primarily when corporate officials go too far in abusing their trust that stockholders bring legal action against the improper conduct. Even then the expense involved in bringing a lawsuit usually discourages intervention by most of the stockholders.

A further aspect of the present-day corporation problem is the impact of large corporations on small business and consumers. This problem centers on the financially large, multiplant corporations; that is, corporations controlling many geographically separate plants in the same and in widely diverse lines of business. Large financial size has recognized *private* advantages. At the same time, however, it may result in a number of economic evils. First, large size in American industry has typically come about as a result of mergers; and mergers in many fields have meant the destruction of price competition among formerly independent and competing plants. With the disappearance of competition, prices have become "administered" and "stabilized." Such forced stability of particular prices tends to prevent full employment and aggravates depression. When demand declines, large business takes little or no action to stimulate consumption by reducing prices. Instead, output is curtailed in order to prevent a break in prices.

Secondly, large financial size has fostered certain types of business behavior which are not in the public interest. Such behavior includes concerted action on prices; discriminatory pricing to limit and injure competitors; blacklisting and boycotting of competitors; tacit agreements to restrict the production, sale, and distribution of particular commodities; price leadership and price following; price rigidity; restrictions on newcomers; coercion of independents; the use of financial power to secure discriminatory purchase prices; undue influence in the legislatures and the courts; suppression of patents, wasteful advertising; spurious product differentiation; technological progress without cost savings being passed on to consumers; inefficiency in the coordination of diverse activities; and backwardness in the introduction of new processes.[7]

Critics of large business units declare that regulatory efforts to curb abuses have been largely ineffective. When one abuse is condemned, business behavior is commonly changed, and the unlawful end is pursued in a modified way. A policy of attacking abuses, it is said, is essentially one of treating symptoms rather than basic causes. If monopolistic behavior is to be reme-

[6] David Lynch, *The Concentration of Economic Power* (New York, 1946), p. 282.

[7] Evidence on the abuses of economic concentration may be found in the reports of the Temporary National Economic Committee (summarized by David Lynch in *The Concentration of Economic Power* [New York, 1946]); in court cases involving monopolistic activity and discriminatory pricing; in Congressional reports on monopoly and economic concentration; and in the reports of the Federal Trade Commission and the Department of Justice.

died, it is believed, government must act *positively* to create the essential conditions for competition, namely (1) numerous, independent buyers and sellers and (2) market rules for conducting business openly and aboveboard.

FEDERAL CHARTERS OR LICENSES AS A REMEDY FOR CORPORATE ABUSES

Government reports and court cases are filled with factual information demonstrating that a large part of our present economic ills are traceable to (1) the gaps, vagaries, and laxity of corporation law and (2) the concentration of economic power in the hands of a few corporations in each industry. As a result of the charter-issuing policies of the states, there is a deplorable absence of rules and standards for the organization and internal government of business corporations.

Today, we are faced with the alternatives (1) of being contented with the abuses of concentrated economic power as we know them or (2) of taking consistent action to remedy these evils. There is general agreement among students of public policy that the conservative, practical approach to take in regulating corporate enterprise is one of establishing *uniform standards* in the public interest for all corporations engaged in interstate commerce. In some cases, such standards can be applied effectively by existing federal commissions. In other cases, and as a supplementary mechanism, various experts believe that standards for corporate activity should be enforced through a system of federal charters or licenses.[8]

The proposal of requiring federal charters or licenses for corporations engaging in interstate commerce is one which many economists regard as being of paramount importance. By establishing standards and "rules of the game" which must be observed by corporations as a condition for (1) coming into existence and (2) engaging in interstate commerce, public regulation can do much to prevent the development of abuses and the exercise of private monopoly power.

A system of federal charters or licenses would greatly simplify the problem of business regulation. Business enterprisers seeking to enjoy (1) the valuable privileges of a corporate charter and (2) the right to engage in interstate commerce would be granted charters provided that they would agree to fulfill designated responsibilities in the public interest. The securing of valuable corporate privileges would be made to turn on the assumption of far greater obligations to the public than the payment of filing fees and annual

[8] Since state governments receive filing fees and annual license or franchise taxes from business corporations chartered in their states, some authorities believe that the states should be allowed to continue their control over the granting of corporate charters. The attainment of uniform standards in corporate regulation, they suggest, can be secured under state laws by requiring *federal licenses* as a condition for engaging in interstate commerce.

SAMPLE COPY

Certificate of Incorporation

OF THE

This is to Certify That we .....

do hereby associate ourselves into a corporation, under and by virtue of the provisions of Title 14, Corporations, General, Revised Statutes, and the several supplements thereto and acts amendatory thereof, and do severally agree to take the number of shares of capital stock set opposite our respective names.

First: The name of the corporation is

Second: The location of the principal office is ..... Street,

in the of , County of

The name of the agent therein and in charge thereof, upon whom process against this corporation may be served, is

Third: The objects for which this corporation is formed are . . .

[The objects for which a corporation is formed are determined and placed in the certificate of incorporation by the persons who apply for the charter.

Most certificates of incorporation provide for the buying and selling of real estate and for the transaction of any business which will enhance the value of the stock of a corporation. The right to buy, own, vote, and sell the stock of other corporations is also usually included.]

The corporation shall also have power to conduct its business in all its branches, have one or more offices, and unlimitedly to hold, purchase, mortgage and convey real and personal property in any State, Territory or Colony of the United States and in any foreign country or place.

Fourth: The total authorized capital stock of this corporation is

Fifth: The names and post-office address of the incorporators and the number of shares subscribed for by each, the aggregate of which ($) is the amount of capital stock with which this company will commence business, are as follows:

Name.	Post-Office Address	Number of Shares.

Sixth: The period of existence of this corporation is unlimited.

In Witness Whereof, we have hereunto set our hands and seals the

day of , A. D. nineteen hundred

Signed, sealed and delivered in the presence of .....

franchise taxes, as is largely true today (see Figure 36). In setting forth desirable courses of conduct, government would act to minimize the development of abuses. "An ounce of prevention," it has been said, "is worth a pound of cure"; and this maxim applies fully to the regulation of business.

A plan of federal charters or licenses also would provide for a system of regulation which is largely self-enforcing. The inclusion of strict terms in corporation charters would give management, directors, stockholders, and the public a knowledge of their respective rights and duties. Stockholders would be informed of their rights against management, and management would know the standards which they should observe in relation to stockholders and the public. The self-interest of stockholders and the public would thereupon be enlisted to see that corporations observe the rules which were agreed upon as a condition for doing an interstate business.

SUGGESTED TERMS AND CONDITIONS FOR CORPORATIONS ENGAGING IN INTERSTATE COMMERCE

Various standards have been proposed for inclusion by the federal government in charters or licenses to corporations seeking to engage in interstate commerce. In summary form, they include the following:

1. Prohibition of interlocking relationships between nominally independent corporations either engaged in the same line of industry or buying and selling from each other in interstate commerce.

2. The issuance of adequate official publicity by corporate managements in reliable, useful, and complete reports. Corporations with securities listed on a national exchange must provide such information in reports to the SEC. Similar requirements apply to companies subject to the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940. However, there are no laws, state or federal, which require corporations with unlisted securities, traded over the counter, to provide reliable reports, even to their own stockholders.

In 1946, and again in 1949, the SEC made a study of the financial reports of a representative group of corporations which do not file their statements with the Commission. *Most* of these reports, it was found, were misleading or inadequate in some degree. The SEC has repeatedly urged Congress to enact legislation requiring all corporations having at least $3,000,000 in assets and at least 300 security holders to make public reports to the Commission.

FIGURE 36. (Opposite). The Form of Corporate Charter Used by the State of New Jersey. Note the space (under "Third") in which persons seeking a corporate charter may designate the objects and purposes of the corporation. Some authorities believe that the granting of valuable corporate privileges should be made to involve the assumption of specific obligations in the public interest. Suggested terms and conditions for inclusion in the charter grant are presented in the text.

Such a requirement, the Commission believes, will make it possible to curb false and misleading statements, so that security holders will have a basis for exercising an informed judgment.

3. Full disclosure of transactions by officers and directors with the companies and affiliates of the controlling corporation.

4. Mandatory proxy solicitation at least once a year and the provision of adequate information for use by security holders in exercising their corporate franchise.

5. The restriction of corporate powers to those essential to a single main purpose and kind of business.

6. Stocks of corporations to be owned and voted only by natural persons. This was the law on corporations for many centuries prior to 1888, when New Jersey legalized the holding company privilege. The adoption of this proposal would have the consequence of outlawing completely the holding company device.

7. The establishment by law of a high standard of responsibility for corporate officers and directors in relation to the owners of a corporation. Corporate officials, it is said, should be vested in fact as well as in law with the fiduciary obligation of trustees. Stockholders must have the expectation of fair dealing on the part of their officers and directors, for experience has shown that stockholders' rights cannot be protected by private suits against improper conduct. In most cases, the great majority of stockholders have neither the time nor the money to investigate and prosecute irresponsible corporate officials.

8. A provision that each member of the board of directors must own a certain minimum percentage of the stock of the corporation. Such a provision, it is said, would (1) correct in some degree the present separation of ownership and control and (2) prevent or discourage the election of directors who acquire only a few qualifying shares in order to represent a banking firm or a competing company.

9. A requirement that corporations which control two or more plants making salable products, or which engage in more than one kind or line of business, shall prepare and publish profit and loss statements *for each separate plant and for each distinct kind of business.* Large corporations typically publish only "consolidated" accounting reports which reveal nothing about the profitability of various operations. Some units of a large concern may be deliberately operated at a loss to injure a competitor, and the use of consolidated reports makes it easy to conceal such activity.

10. A provision requiring each publicly held corporation to have a clearly stated dividend policy. When profits are earned, stockholders are entitled to receive a reasonably large share. Some authorities believe that corporate managements should be required to pay out a substantial part of the profits to their stockholders. The percentage of profits required for dividends, it is proposed, should be arranged on a graduated basis, with the percentage low for small corporations and rising to 100 percent for the largest companies.

Advocates of this provision declare that it would (1) protect small stockholders against having their just share of profits used to satisfy the whims of corporate management and (2) aid in preserving the capitalist system by retarding the growth of giant corporations. The federal government, itself, has a very real interest in preventing the unwarranted retention of liquid earnings by corporations. Not infrequently, controlling stockholders promote the accumulation of excessive liquid earnings by a corporation by refusing to declare dividends in order to reduce their personal incomes and avoid heavy personal surtax payments.

11. A provision that a stockholder may cumulate or concentrate his votes on one or more candidates for the board of directors (cumulative voting). By this arrangement a stockholder owning ten shares and voting on nine directors may cast ninety votes for one nominee instead of ten votes for each of nine persons. Cumulative voting gives minority stockholders a greater opportunity of securing an independent director (not closely identified with the operating management). The corporation laws of some twenty-one states now specifically provide for cumulative voting.

12. The legal requirement that the officers and directors of a corporation (not the corporation itself) shall be personally liable for fines growing out of specified violations of the antitrust laws which they conceive and direct.

13. A provision that stockholders shall be permitted to make their own nominations in the election of the management, and that nominations so made shall be included in the soliciting material sent out to the security holders by the management.

14. The development and application of an appropriate standard for size. Congress has made repeated efforts to halt the concentration of economic power. In 1950, we have seen, the Clayton Act was amended to prohibit the acquisition of stock *or assets* which substantially lessens competition. The attention of various economists and statesmen is now turning to the determination of an appropriate standard on size for corporations *which have already attained a dominant position.*

Professor Walter Adams proposes that corporations controlling 10 percent or more of the supply (tons, pounds, or barrels) of a product moving in interstate commerce, or having assets in excess of $25,000,000 shall come under federal scrutiny. If a federal commission finds that the activity of such a corporate giant is characterized by ineffective price competition, unused capacity, and price rigidity, it can provide for an unraveling ("unwinding," "unmerging") of the corporation and for the creation of numerous independent concerns. If, however, the commission finds that the large corporation fully meets standards of performance in the public interest, it can permit the concern to continue.[9]

[9] Hearings Before the Subcommittee on Study of Monopoly Power, Committee on the Judiciary, House of Representatives, 81st Congress, first session, Serial 14, Part 2-B, 1950, pp. 1313-1314; and "Is Bigness a Crime?" *Land Economics*, November, 1951, p. 293.

Other economic experts propose that the Sherman Act be amended to establish a "rebuttable presumption" that concentration in excess of a specified percentage is illegal. Corporations which desire to attain or retain a size in excess of the prescribed limit would be required to justify the large financial size in terms of service to society.[10]

Dr. C. D. Edwards suggests that the "competitive standard" should be taken as our guide for the degree of bigness which is permissible. In his opinion, a large corporation should be open to challenge whenever it appears that its size has "adverse effects" upon competition. The effect of bigness upon competition may be tested by considering (1) whether the *behavior* of the concern is monopolistic or (2) whether its *structure* in relation to others gives it the power to control the market, regardless of the way in which this power is exercised.[11]

SUMMARY

Substantial progress has been made toward providing investors with reliable information on corporate activity and with regulated markets for the purchase and sale of securities. Procedures have also been established to provide for the decentralization of financial control in the organization of electric and gas utilities. The important tasks of the future with respect to supercorporations are mainly two: (1) to establish the responsibility of management to the actual owners, so that stockholders will have some measure of control over their property; and (2) to formulate a public policy with respect to corporate size, mergers, and centralized financial control in the principal fields of industry. There is no logical reason for applying holding company legislation only to the electric and gas utility fields. Centralized financial control and monopolistic price policies similarly exist in the various branches of industry, commerce, banking, and transportation.

Our declared public policy is one of maintaining effective price competition in all lines of business which are not given over to public price control by commissions. In the preceding chapters on the antitrust laws we considered the legislation which the federal government has adopted to eliminate monopolistic practices. The proposal of requiring (1) federal charters for all corporations engaging in interstate commerce and (2) an observance of standards with respect to corporate size and activity is a practical means for *implementing* our traditional antitrust policy.

[10] Report of the Committee on Cartels and Monopoly in George W. Stocking and Myron W. Watkins, *Monopoly and Free Enterprise* (New York, 1951), p. 553. See also Fred I. Raymond, *The Limitist* (New York, 1947), pp. 108–133.

[11] C. D. Edwards, "Public Policy and Business Size," *The Journal of Business of the University of Chicago*, October, 1951, p. 286; and *Big Business and the Policy of Competition* (Cleveland, 1956).

18

State Antitrust Laws

The purpose of the present chapter is to consider the state antitrust laws and their role in maintaining a policy of competition. In the federal system, the regulation of intrastate or local commerce is reserved to the states. Intrastate commerce, in general, is any commercial activity which begins and ends within a state. Although the Supreme Court has broadened the concept of interstate commerce to cover local business which affects commercial activity among the states, there is still an important area of economic activity which is commonly considered to be intrastate and subject only to regulation by the individual states.

The area of intrastate commerce is significant. It typically includes, or may include, the production and sale of bread, beer, local wines, gasoline, ice, coal, fuel oil, lumber, milk, ice cream, local produce, used cars, insurance, cleaning and dyeing, laundry, hospital services, undertaking services, cemetery services (including gravestone installation), garage services, parking facilities, hotel and housing facilities, building and road construction, photoengraving, printing, theater and recreational facilities, local transportation, and banking services. A large number of personal service enterprises are local in nature. They include the activities of architects, barbers, optometrists, physicians, surgeons, dentists, pharmacists, accountants, photographers, surveyors, and veterinarians. Numerous heavy and bulky products, such as cement, sand, gravel, bricks, concrete building blocks, and drain tile, are also produced and consumed locally because of high transportation costs.

Within the area of local commerce, the state governments have the task of performing the same economic functions of regulation which the federal government performs at the national level. Such functions include the prohibition of false advertising, the prevention of monopoly and unfair competition, the control of local utilities, and the adoption of labor legislation for local trades. The incorporation of business enterprises and the regulation of insurance companies, as we have seen, continue to be exercised by the states, even though the enterprises actually engage in interstate commerce.

STATE PROVISIONS RELATING TO MONOPOLY AND RESTRAINT OF COMPETITION

The constitutional and statutory provisions against monopoly which have been adopted by the state governments are a reflection of the general belief of consumers, farmers, labor, and independent businessmen that a policy of competition is essential to their economic welfare. Some twenty-seven states have adopted constitutional provisions which condemn monopoly, restraint of trade, restraint of competition, price fixing, and, in some cases, concerted action to limit output (see Table 25, pages 400–401). Some forty-one states, moreover, have enacted statutory provisions against such offenses.

A few examples of the constitutional prohibitions will serve to indicate the strong feeling of the state founders against monopoly. According to the constitution of Arizona, "Monopolies and trust shall never be allowed in this State, and no incorporated company, copartnership, or association of persons in this State shall directly or indirectly combine or make any contract . . . to fix the prices, limit the production, or regulate the transportation of any product or commodity. The legislature shall enact laws for the enforcement of this section by adequate penalties, and in the case of incorporated companies, if necessary for that purpose, may, as a penalty, declare a forfeiture of their franchises." The principle that monopolies "shall never be allowed" is also expressed in the constitutions of Arkansas, Tennessee, Texas, Washington, and Wyoming.[1]

The constitution of New Hampshire provides that "free and fair competition in the trades and industries is an inherent and essential right of the people and should be protected against all monopolies and conspiracies which tend to hinder or destroy it."

In South Carolina the constitution provides that "the general assembly shall enact laws to prevent all trusts, combinations, contracts, and agreements against the public welfare."

The constitution of Louisiana declares that "all combinations, trusts, or conspiracies in restraint of trade or commerce, and all monopolies or combinations to monopolize trade or commerce, are hereby prohibited in the State of Louisiana."

The constitution of North Carolina provides that "perpetuities and monopolies are contrary to the genius of a free state and ought not to be allowed"; and the constitution of Maryland declares that monopolies "are odious, contrary to the spirit of a free government and the principles of commerce, and ought not to be suffered."

[1] A compilation of state antitrust law provisions is presented in *State Antitrust Laws and State Price Control Legislation*, prepared by the Marketing Laws Survey, Works Progress Administration (Washington, 1940); and *Final Report on the Chain Store Investigation*, 74th Congress, first session, Senate Document 4, 1935.

STATUTE PROVISIONS WITH RESPECT TO MONOPOLISTIC RESTRAINTS

The state legislatures in Idaho, Louisiana, Maine, New Mexico, New York, and Wisconsin have adopted antitrust statutes which are essentially the same as the Sherman Act of 1890. The Attorney General for Hawaii has recommended that legislation be adopted to insure the continued application of the federal antitrust laws to commerce within its jurisdiction. Thirteen states (Arizona, California, Florida, Kansas, Mississippi, Montana, Nebraska, New Hampshire, North Dakota, Ohio, South Dakota, Texas, and Virginia) have enacted antitrust statutes similar to the following (which is the wording of the Ohio statute):

A trust is a combination of capital, skill, or acts by two or more persons, firms, partnerships, corporations, or associations . . . for either, any, or all of the following purposes:

[1] To create or carry out restrictions in trade or commerce.
[2] To limit or reduce the production, or increase or reduce the price, of any commodity or merchandise.
[3] To prevent competition in manufacturing, making, transportation, sale, or purchase of merchandise, produce, or commodity.
[4] To fix at any . . . standard . . . figure . . . its price to the public or consumer. . . .
[5] To make or enter into . . . any contracts, obligations, or agreements . . . not to sell, dispose of, or transport any article . . . below a common standard figure or fixed value . . . or settle the price of any article . . . between themselves and others, so as to directly or indirectly preclude a free and unrestricted competition among themselves. . . . Every such trust as is defined herein is declared to be unlawful, against public policy, and void.

In general, it may be said that all the state antitrust statutes seek to prevent collective action which is designed to restrain price competition or to prevent others from exercising a trade of their own choice.

Many states having antitrust statutes, as well as those not having such legislation, have provided that agricultural cooperatives and labor unions shall not be deemed to be illegal combinations. States which have resale price-maintenance legislation also have provided that resale price-maintenance contracts shall be exempted from the antitrust laws. The various state antitrust laws provide for the levying of fines up to $5000 for each violation and for imprisonment for periods ranging from six months to ten years. Enforcement of the state antitrust laws is normally a duty of the state attorney general, and in some cases the county and district attorneys are also given the responsibility of enforcement.

SPECIAL ANTITRUST LAWS FOR LOCAL COMMERCE

Nearly all of the states have adopted one or more special antitrust statutes applicable to certain designated industries. These statutes, in most cases, reflect the existence of some particular commercial abuse which the legislatures have sought to correct by specific legislation. Many of the special statutes provide that railroad corporations shall not own parallel or competing lines. Special regulations are also commonly provided for the prevention of restraints in the wholesale and retail liquor business. Some states—such as Arkansas, Arizona, Iowa, Kansas, Louisiana, Michigan, New Hampshire, Nebraska, Oregon, South Carolina, South Dakota, and Washington—provide that fire insurance companies shall not be permitted to make agreements or understandings to fix or maintain insurance rates or premiums. Wisconsin has a special statute providing that Swiss cheese dealers shall have their licenses revoked if they are found to be engaged in any practice in restraint of competition. Alaska has a statute which provides basically for a forfeiture of the leases of any coal lands held by an "unlawful trust" or when they are the "subject of any contract or conspiracy in restraint of trade in the mining or selling of coal" entered into by the lessee. Other states have special antitrust statutes applicable to pipelines, banks, stockyards, cold storage enterprises, grain dealers, bridge owners, cotton gin operators, motor carriers, advertising companies, electrical utilities, the purchase of tobacco and grain, and the sale of news service, coal, various foodstuffs, and commercial fertilizers.

From an economic and legal standpoint, special antitrust laws applicable to general business are an incomplete instrument of control. The protection of consumers requires that price competition be effectively maintained in *all* lines of business which are not turned over to public price fixing by commissions. It follows that what is needed is a broad, general, and comprehensive statute, applicable to the sale of all commodities (physical products and services—such as the services of dry cleaners, architects, garages, and barbershops). Thereupon, if additional legislation is found to be necessary to cope with restrictive agreements in special situations—such as agreements between agricultural cooperatives, labor unions, railroads, electrical utilities, or other industries or activities in which various degrees of monopoly control are accepted—it could be adopted to supplement the general antitrust statutes.

STATE STATUTES PROHIBITING PRICE DISCRIMINATION

By the time the Clayton Act was passed by Congress in 1914, nineteen states had already adopted legislation against geographic price discrimination which works an injury to competition. The purpose of these statutes

was to prevent the common practices of large sellers in (1) cutting selling prices in one area to destroy a local competitor, while raising or maintaining the prices on like products in other areas; or (2) raising buying prices in a certain community in which a competitor was located, while making up losses by paying low prices in areas in which competition was not active.

At the present time, some twenty-seven states have comprehensive statutes which prohibit, with various qualifications, any person or corporation, engaged in the production, manufacture, or sale of a commodity, from engaging in geographic price discrimination (see Table 25, pages 400–401). Some of the statutes specify that the prohibition extends to "*selling* such commodity at a lower rate in one section, community, or city . . . than such person . . . charges for such commodity in another section, community, or city . . . after making due allowance for the difference, if any, in the grade or quality and in the cost of transportation" (Delaware). Other statutes (such as the Iowa law) provide that the prohibition shall cover "*purchasing* said commodity at a higher rate or price in one section, locality, community, city, or town than is paid for such commodity by such party in another section . . . after making due allowance for the difference, if any, in the grade or quality and in the actual cost of transportation." This difference in the two types of statutes reflects the fact that in certain states the problem has been one of preserving selling competition (between manufacturers, wholesalers, and retailers), whereas in agricultural communities the principal problem has been one of maintaining buying competition in the purchase of farm products. Practically all the statutes qualify the prohibition on discrimination by adding the phrase "for the purpose of creating a monopoly or destroying the business of a competitor."

In some states (such as Mississippi) the law against geographic price discrimination extends to buying as well as to selling activities. The Wisconsin statute covers discrimination between persons *within* the same locality (personal discrimination) and also discrimination between two or more areas. The various antidiscrimination laws are criminal statutes and provide for the levying of fines or imprisonment, or both. Their enforcement is typically a duty of the state attorney general.

Although state statutes prohibiting geographic price discrimination are designed to restrict freedom of contract, the state and federal courts have uniformly upheld such laws if "intent" to destroy competition is included as a part of the offense. The Supreme Court of Iowa, in upholding the validity of an antidiscrimination statute in that state, for example, declared:

> One of the greatest legislative problems of the day is to protect fair competition in the business world without unduly interfering with the freedom of contract. . . . It is quite manifest that a company sufficiently large in its capital and in the scope of its business could obtain a monopoly for itself in whatever territory it chose, by adopting the methods which are enumerated and prohibited in the statute. The temporary maintenance of artificial prices for the sole purpose of destroying a weaker competitor and

creating a monopoly is one of the modern evil inventions. All that is required for its sure success is that there be great inequality of financial resources in favor of the offending party.[2]

In 1912 the United States Supreme Court upheld the antidiscrimination statute of South Dakota. This code reads, in part, as follows: "Any person doing business in this State . . . *who intentionally, for the purpose of destroying the competition* of any regular established dealer . . . or . . . the competition of any person . . . shall discriminate between different sections, communities, or cities of this State by selling such commodity at a lower rate in one section . . . than such person . . . charges for such commodity in another section . . . after equalizing the distance from the point of production . . . shall be deemed guilty of unfair discrimination" (italics supplied). The company charged with discrimination contended that the law was illegal because it unreasonably limited freedom of contract. Justice Holmes, however, speaking for a unanimous Court, upheld the statute on the ground that if an instrument of trade war is found to be against public policy, its use may be prohibited.[3]

In addition to the comprehensive statutes prohibiting geographic price discrimination, many states have adopted special laws against geographic price discrimination (see Table 25, pages 400–401). A number of states (Arizona, Indiana, Mississippi, Missouri, Nebraska, North Dakota, Ohio, Oregon, South Dakota, Tennessee, Utah, Vermont, and Wisconsin) have laws which prohibit discrimination in the buying of milk, cream, or butterfat with the intention or for the purpose of destroying or injuring the business of a competitor. Some states extend the prohibition to the buying of agricultural products typically produced within their borders (Arkansas, Idaho, Michigan, Minnesota). Florida has a special law with respect to price discrimination in the sale of commercial fertilizer, and Kansas has a special law prohibiting price discrimination in the sale of news and news reports.

THE ATTEMPT OF MINNESOTA TO PROHIBIT PRICE DISCRIMINATION WITHOUT REGARD TO INTENT OR PURPOSE

A Minnesota statute of 1909 prohibited local price discrimination whenever it was done "with the intention of creating a monopoly or destroying the business of a competitor." The difficulty of proving "intent" or "purpose" led the legislature in 1923 to amend the law by making geographic price discrimination illegal, *without regard to intent or motive*. A *given* buyer of farm products, for example, was required to pay *his customers* the same price for like commodities at all points of purchase, after making

[2] *State* v. *Fairmont Creamery of Nebraska*, 133 N.W. 895, 898 (1911).

[3] *Central Lumber Co.* v. *South Dakota*, 226 U.S. 157 (1912).

proper allowance for transportation costs. The paying of higher prices in one local area "to meet competition" while paying lower prices elsewhere was not permitted.

In 1924 the state of Minnesota brought action under the new antidiscrimination statute against the Fairmont Creamery Company, a large centralized creamery located in Sioux City, Iowa. This creamery maintained buying stations for butterfat at various points in Minnesota and was engaged in paying higher prices at certain points than at others, after making due allowance for transportation costs. In attempting to justify this action, the company contended that freedom of contract, guaranteed by the Constitution, gave it the right to pay higher prices in one locality as compared with another, in order to "meet" the buying competition of local creameries. The state of Minnesota, on the other hand, replied that freedom of contract is not absolute, and that the statute was enacted to prevent the very practice employed by the company.

The Supreme Court of Minnesota in 1925 upheld the validity of the antidiscrimination statute on the ground that the act was designed to prevent the use of price discrimination by large centralized creameries to injure locally owned cooperative and independent creameries.

A centralized creamery [said the Court], supplied with ample capital and facilities, has the ability and meets the temptation to destroy competition at a buying station by overbidding, absorbing the resultant losses, if any, through the profits of its general business, and, when competition is ended, to buy on a noncompetitive basis. If it does all this successfully, it has a monopoly, and may or may not treat producers justly. The statute seeks to prevent the destruction of competition by forbidding overbidding unless the dealer makes prices at other buying points correspond after proper allowances for the cost of transportation. If the statute is obeyed, destroying competition is expensive.[4]

Upon losing the decision in the state supreme court, the Fairmont Company appealed its case to the United States Supreme Court. A divided Court, with Holmes, Brandeis, and Stone dissenting, held that the state could not so restrict the "freedom of contract." Since the statute prohibited discrimination "irrespective of motive," the Court declared that it was "an obvious attempt to destroy plaintiff in error's liberty to enter into normal contracts, long regarded, not only as essential to the freedom of trade and commerce, but also as beneficial to the public."[5]

A study of price determination in open markets indicates that the Court was in error in taking the view that business done *at discriminatory prices* is the "usual way heretofore regarded as both moral and beneficial to the public." The "usual way" of doing business which has moral, legal, and economic sanction is in open markets, with *each* trader treating *his* customers

[4] *State* v. *Fairmont Creamery Co.*, 202 N.W. 714, 716 (1925).

[5] *Fairmont Creamery Co.* v. *Minnesota*, 274 U.S. 1, 9 (1927).

essentially alike at any given time. In the Fairmont Creamery case there were no competitive markets for cream at the various collecting stations along the same rail line, as the Court assumed. At some points the company had the advantage of a monopoly condition, and at others the presence of an independent creamery made necessary the payment of a higher price.

The method of competition accepted by a divided Court in the Fairmont Creamery case has long been condemned by many economists as unfair. With the advantage of local monopoly power in one area, a large buyer is in a position to pay unduly low prices at certain points and artificially high prices at others. Under such conditions, a small plant operating in one area only does not have a chance to survive on its merits. Experience has shown that it is necessary to restrain the power of discrimination whenever it works injury to competition.

The Fairmont Creamery case (1927) was the last antitrust case brought by the State of Minnesota. Its attempt to restrain geographic discrimination in business, without regard to motive, was frustrated by the Supreme Court. To prove illegal intent is impossible in most instances. This means that state antidiscrimination statutes now rest on the books unused. With the changed attitude of the Supreme Court toward state action regulating prices which was adopted during the great depression, it is possible that the Court would now look with favor upon the Minnesota statute (see Chapter 20, pages 435–436). If the practice of injurious price discrimination is to be restrained, all of the states will need to adopt new statutes condemning injurious discrimination, regardless of motive.

ANTITRUST LAW ENFORCEMENT AT THE STATE LEVEL

Antitrust enforcement is active in New York, Texas, Missouri, and Wisconsin. In all other states, as many of the attorneys general report, "antitrust activity is dormant." Typically, the state governments have no special staffs to enforce their antitrust laws and the attorneys general have no special funds for this purpose.

Inasmuch as most of the state governments have had little or no experience with the enforcement of antitrust laws, it is evident that the idea of maintaining a policy of competition does not prevail in the minds of their citizens. Most of the states report that they do not receive complaints of monopolistic restrictions. The institution of competition, it appears, is not understood; and citizens are not actively concerned with deviations from competitive behavior.

In states such as New York, Wisconsin, Texas, and Missouri, where antitrust enforcement is on the other hand active, local citizens know about and expect competitive behavior in business. The attorney general for Wisconsin, for example, provides the following report on antitrust enforcement in that state:

Industries and trades in which we have had complaints include the following: milk, bread, gasoline, burial supplies, typewriters, canning vegetables, tobacco, appliances, laundries, lumber, plaster, cement, phonographic records, plumbing and electrical supplies, drugs, used cars, automobile parts, calcium chloride, salt, beer, power tools, sporting goods, cooking utensils, athletic equipment, barbers, and architects. . . .

We receive from 50 to 100 complaints annually.

During the last ten years we have brought eight civil actions in the circuit courts. We have brought five proceedings before the State Department of Agriculture which has power under sec. 100.20, Wis. Stats., similar to Federal Trade Commission powers. We act upon all complaints. Each is studied. If the compaint seems to have no merit, the complaining party may be asked to furnish additional facts. About half the complaints receive some form of field investigation. About fifty complaints have been subjected to formal investigation with witnesses giving sworn testimony and producing documentary evidence before this office, a court commissioner, or a magistrate.

Two of the lawyers on the staff of this office devote a major portion of their time to anti-trust work.[6]

ANTITRUST ACTIVITY IN NEW YORK

The Attorney General's office for New York State reports that it receives more than fifty antitrust complaints a year. These complaints have dealt with the distribution of products such as milk, laundry, bread, and carbonated beverages by or to retailers; local manufacturing; bidding for public contracts; and the sale of delicatessen products, wallpaper, cemetery markers, milk, ice cream, wrapping paper, theater tickets, and appliances. The types of alleged restraints in the various complaints included allocation of customers, price fixing, mergers, refusals-to-sell, tie-in sales, and exclusive dealing arrangements.[7]

The New York office of the Department of Justice reports that it receives about fifteen antitrust complaints each year which are mainly or entirely *intrastate* in nature—and which it does not consider. The items in such complaints include bread, milk, cigarettes and other goods sold in candy stores, medical care, laundry, garbage removal, photo-finishing, advertising, and the manufacturing of ladies' belt buckles. The New York office of the Federal Trade Commission similarly reports that it receives about forty complaints a year which it does not prosecute because they are local or have only limited effect on interstate commerce.

In other states, the Department of Justice reports, it has received complaints of local monopolistic activity in the sale of articles and services similar to those in the New York complaints, as well as in dry cleaning, the sale

[6] Quoted in *Report of the Special Committee to Study the New York Antitrust Laws*, New York State Bar Association, 1957, p. 115a.

[7] *Ibid.*, pp. 50a–53a.

of cemetery markers, the furnishing of linen supplies, the distribution of beer, bread, and eggs, mortgage banking, the fixing of real-estate commissions, the sale of ready-mixed cement, and newspaper publishing.[8]

It is sometimes said that state antitrust law enforcement is unnecessary, for there are no problems of monopolistic restraints as there were when the statutes were adopted. The foregoing evidence points to the contrary. The facts are that there are restraints at the state level of the same kind as those prosecuted by the federal agencies. If these practices are to be curbed, it will be necessary for citizens in the respective states to revitalize their antitrust statutes.

THE AREA OF STATE ENFORCEMENT RESPONSIBILITY

The general rule developed by the courts is that the federal government can reach local restraints *whenever interstate commerce is affected*. As Justice Jackson stated in the Sportswear case, "If it is interstate commerce that feels the pinch, it does not matter how local the operation which applies the squeeze."[9]

The degree of effect on interstate commerce is considered by the courts on a case-by-case basis. In one instance, the Supreme Court held that a statewide medical plan which made "sporadic and incidental" payments for out-of-state services did not have a sufficient effect on interstate commerce to call for federal intervention.[10] In general, it appears that the Court in deciding the effect on commerce follows the maxim of *de minimus*—that is, to approve federal intervention only when the effect on interstate commerce is more than a trifle.

The Department of Justice and the Federal Trade Commission report that the principal areas of business in which insufficient interstate commerce is typically found are retailing, distribution of products to retailers and users, and manufacturing for local consumption. It is in these areas, accordingly, that the state governments have the primary responsibility for maintaining competition—if it is to be maintained.

STATE ANTITRUST ACTION TO RE-ENFORCE FEDERAL POLICY

A related question on jurisdiction is whether a state government can prosecute local monopolistic action which bears upon *interstate* commerce. The Department of Justice and the Federal Trade Commission, in fact, prosecute only a small fraction of the complaints they receive. Their efforts, moreover,

[8] *Ibid.*, pp. 50a–52a.
[9] *U.S.* v. *Women's Sportswear et al.*, 336 U.S. 460, 464 (1949).
[10] *U.S.* v. *Oregon Medical Society*, 343 U.S. 326 (1952).

are typically concentrated on restraints which are national in scope and which serve to mark a pattern for other industries.

The *Report of the New York State Bar Association on the New York State Antitrust Law* takes the position that state regulation should complement federal law "even when applied to activities affecting interstate commerce." The report compiled numerous complaints of local restraints bearing upon interstate commerce in which the federal agencies have not proceeded. In failing to take action, the report states, the federal agencies were "undoubtedly . . . influenced by limitations of manpower and budget and the greater urgency of policing monopolistic practices in industries operating over many states." The report continues, "It is doubtful, therefore, whether these complaints will be investigated, and that such wrongs as may be found will be redressed, unless the state takes effective action. We can see no reason why these segments of our economy should not be safeguarded against restraints of trade and monopolistic restrictions."[11]

The State of Wisconsin has taken the position that it can, and should, proceed against local monopolistic restraint even though interstate commerce may be affected. According to its Antitrust Division,

> We have so far escaped any major jurisdictional problems and any jurisdictional conflicts. We take the position that even though a conspiracy or combination in restraint of trade may be interstate in its operation, if part of it is executed in Wisconsin and affects or restrains local commerce, it is a violation of our state antitrust law. So far no one has successfully challenged our jurisdiction, although we call upon out-of-state corporations which do business in Wisconsin within the meaning of the antitrust law, to furnish us with information and stand trial where called upon.

PRIVATE DAMAGE SUITS AT THE STATE LEVEL

Few persons seem to know that the treble damage provision is a common feature of the state antitrust laws. If, and when, this information becomes more widely known, it is possible that private suits will become an important factor in state antitrust law enforcement. Private damage suits are a useful device in securing antitrust law enforcement; however, primary reliance should be placed on action by a state enforcement agency.

The Idaho antitrust law contains a typical treble damage provision. It provides that "any person who shall be injured in his business or property . . . by reason of anything forbidden or declared unlawful . . . may sue therefor . . . and shall recover threefold the damages by him sustained and the costs of suit, including a reasonable attorney's fee." The sales-below-cost statutes of nine states also permit the recovery of treble damages. Any person, it is

[11] *Report of the Special Committee to Study the New Antitrust Laws*, New York State Bar Association, 1957, p. 7.

Sock Him Again if You Find an Opening!

FIGURE 37. A Cartoon from the *Milwaukee Journal* Illustrating the Enthusiastic Popular Support of the Action Taken by the State Attorney General of Wisconsin Against the Retail Gasoline Dealers of Milwaukee. (By permission)

usually provided, who is injured by a violation of the act may sue for three times the actual damages sustained. State statutes having this provision are those of Arkansas, Colorado, Kentucky, Maine, Michigan, Montana, Oregon, Utah, and West Virginia. In the California antitrust law there is provision for private suits by injured parties either for an injunction or for double damages or both.

The Indiana antitrust statute has an unusual provision which may have possibilities of relief for industrial buyers and consumers who are faced with monopolistic pricing in local trades—as in milk, cement, bricks, gasoline, caskets, funeral services, cleaning and pressing, and the laundering of clothes. The statute provides that "any person or persons or corporations that may be injured or damaged . . . may sue and recover . . . the full consideration or sum paid by him or them for any good, wares, merchandise or articles the sale of which is controlled by such combination or trust." This provision is also found in the antitrust laws of several other states.

TABLE 25. State Antitrust Statutes

State	Antitrust Laws Prohibiting Monopoly, Restraint of Trade, Restraint of Competition, Price Fixing, and/or Limitation of Output		Special Antitrust Laws Applicable to Designated Industries	Antidiscrimination Statutes	
	Constitutional Provision	Statutory Provision		General	Special
1. Alaska	none	none	x	none	none
2. Alabama	x	x	x	none	none
3. Arizona	x	x	x	none	x
4. Arkansas	x	x	x	x	x
5. California	none	x	x	x	x
6. Colorado	none	none	x	x	none
7. Connecticut	x	x	x	none	none
8. Delaware	none	none	x	x	none
9. Florida	none	x	x	x	x
10. Georgia	x	x	x	none	none
11. Hawaii	none	pending	none	none	none
12. Idaho	x	x	x	x	x
13. Illinois	x	x	x	none	none
14. Indiana	none	x	x	none	x
15. Iowa	x	x	x	x	x
16. Kansas	none	x	x	x	x
17. Kentucky	x	none	x	x	x
18. Louisiana	x	x	x	x	none
19. Maine	none	x	x	none	none
20. Maryland	x	none	x	none	none
21. Massachusetts	none	x	x	x	none
22. Michigan	none	x	x	none	x
23. Minnesota	none	x	x	x	x
24. Mississippi	x	x	x	x	x
25. Missouri	none	x	x	x	x
26. Montana	x	x	x	x	x
27. Nebraska	x	x	x	x	x
28. Nevada	none	x	x	none	none
29. New Hampshire	x	x	x	none	none
30. New Jersey	none	x	x	none	none
31. New Mexico	x	x	x	none	x
32. New York	none	x	x	none	x
33. North Carolina	x	x	x	x	none
34. North Dakota	x	x	x	x	x
35. Ohio	none	x	x	none	x
36. Oklahoma	x	x	x	x	none
37. Oregon	none	none	x	x	x
38. Pennsylvania	none	x	x	none	x
39. Rhode Island	none	x	x	none	none
40. South Carolina	x	x	x	x	x
41. South Dakota	x	x	x	x	x
42. Tennessee	x	x	x	none	x
43. Texas	x	x	x	none	x

TABLE 25 (*Continued*)

State	Antitrust Laws Prohibiting Monopoly, Restraint of Trade, Restraint of Competition, Price Fixing, and/or Limitation of Output		Special Antitrust Laws Applicable to Designated Industries	Antidiscrimination Statutes	
	Constitutional Provision	Statutory Provision		General	Special
44. Utah	x	x	x	x	x
45. Vermont	none	x	x	none	x
46. Virginia	x	x	x	x	none
47. Washington	x	x	x	x	none
48. West Virginia	none	none	x	none	none
49. Wisconsin	none	x	x	x	x
50. Wyoming	x	x	x	x	x
Total	27	41	49	27	28

REASONS FOR THE NONENFORCEMENT OF STATE ANTITRUST STATUTES

At the present time, most of the state antitrust laws are "sleeping beauties" because (1) the state legislatures have failed to provide funds for enforcement and (2) they have failed to create effective machinery for enforcement.

The condition of antitrust law enforcement at the state level is hurtful evidence for those who advocate and believe in states' rights as against federal intervention. Today, for the most part, there is little or no protection for consumers against excessive, monopolistic prices in important areas of *intrastate* commerce.

A basic reason for the failure of state legislatures to provide funds for enforcement is the fact that often many state politicians secure the support of local industries in winning their elections. Thereupon, such officials are not in a position to attack the people and business firms who aided them. In many states persons pulling the strings in state politics do not want the state antitrust laws enforced. How can this situation be corrected? At the present time, an opportunity exists for young, ambitious lawyers to take the case of state antitrust law enforcement to the people by running for the office of attorney general. Young men and women having a broad interest in politics also have an opportunity to seek election to the state legislatures on a platform of activating state antitrust legislation to curb monopolistic restrictions.

If the state governments, generally, do not take steps to provide for a vigorous enforcement of their antitrust laws, it would appear that consumers

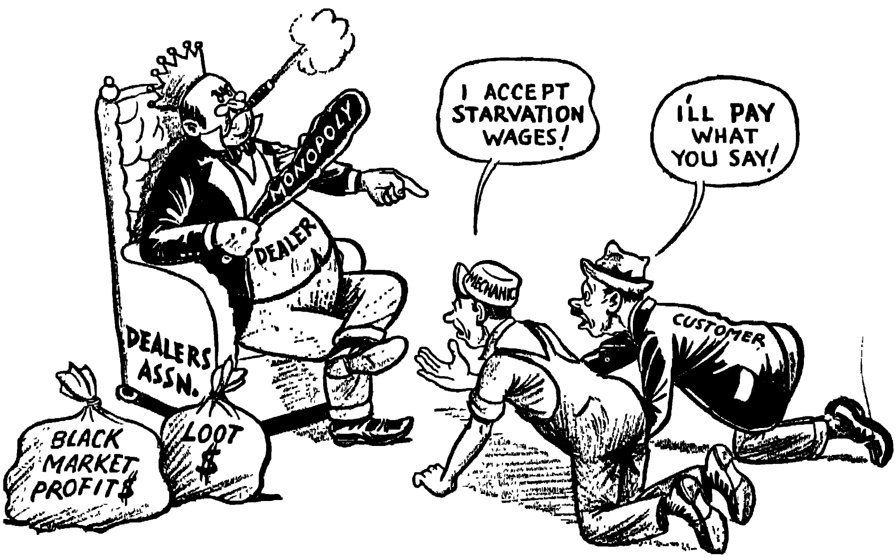

FIGURE 38. A Cartoon from a Labor Bulletin Urging the State Attorney General to Enforce the Antitrust Law in the State of Washington. (By permission)

will face a continuing problem of high costs of living in fields where monopolistic practices exist. Some groups of consumers may be able to maintain their relative position by union activity in pressing for higher wage demands. A great many consumers, however, have no alternative but to pay the noncompetitive prices. Such prices inevitably mean a lower level of living, for production under conditions of monopoly is restricted to amounts which can be sold at the prices which sellers would *like* to get.

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Resale Price-Maintenance and Sales-Below-Cost Statutes

Many state governments have enacted laws for the declared purposes of preventing loss-leader selling and sales below cost. They are variously known as (1) "fair-trade" or resale price-maintenance acts and (2) "unfair-practices" acts. In the present chapter we shall consider the nature and purposes of the laws, as well as the principal arguments for and against their application.

RESALE PRICE MAINTENANCE

A resale price-maintenance law makes it possible for a manufacturer or distributor of products bearing the "trademark, brand, or name of the producer" to fix by contract the minimum or actual wholesale and retail prices of such products as they move on to the final consumers. Such a control of prices is called *resale* price maintenance. It is also called by its proponents "fair trade," because from their standpoint pegged resale prices make for fair merchandising activity.

Although New Jersey enacted a permissive resale price-maintenance law as early as 1914, it was not until the adoption of the California Fair Trade Act of 1931 and its significant amendment of 1933 that states generally adopted laws legalizing resale price control. At the present time, all of the fifty states have fair-trade laws except Alaska, Missouri, Nebraska, Utah, Texas, and Vermont. The states of Alaska, Missouri, Texas, and Vermont have never had fair-trade laws; and the laws of Nebraska and Utah have been declared unconstitutional by their respective courts of last resort. The District of Columbia does not have a resale price-maintenance statute.

Resale price-control laws do not provide for enforcement by the public authorities. Legal action against alleged violators must be taken by individuals or corporations. Most of the laws provide that suit may be brought by

"any person damaged." In some instances, manufacturers establish special departments to enforce their fair-trade programs. In other instances, trade associations assess dealers for funds to police the programs and prosecute violations. The enforcement of resale price arrangements, however, is based primarily *on persuasion.* Every effort is made to convince low-profit sellers that fair trade is necessary and beneficial. When persuasion fails, resort is made to litigation.

Experts on fair trade advise their clients that a fair-trade merchandising system requires rigid enforcement. If established prices are not systematically enforced, price competition will develop and "fair-trade" retailers will be forced to lower their prices.

BACKGROUND FOR THE ENACTMENT OF RESALE PRICE-MAINTENANCE LAWS

The growing sale of specialty products with distinctive brands and trademarks, particularly after 1900, gave rise to efforts on the part of certain manufacturers to control the resale prices of their products. Since such products were often unique and distinctive, their manufacturers frequently had power to manage prices; and attempts were made in certain cases to enhance profits by fixing prices at the wholesale and retail levels. Government agencies charged with enforcing the antitrust laws, however, took the position that vertical agreements to maintain resale prices were an illegal restraint of trade.

The leading case declaring resale price contracts illegal was one involving the Dr. Miles Medical Company. This company had made contracts with over 400 wholesale dealers and some 25,000 retailers to maintain stipulated prices at wholesale and at retail. Each violation of the contract carried a penalty of $25 and the prospect of a cessation of business relations. The defendant was accused of securing supplies for sale at less than the stipulated prices; and action was brought to test the validity of the restrictive agreements.

The Court in the Miles case held that resale price contracts were in violation of the Sherman Act in that they substantially lessened or eliminated competition among the wholesalers and also among the retailers of Miles products. In the words of the Court, "The complainant having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic."[1] The Federal Trade Commission Act, passed in 1914 to outlaw "unfair methods of competition," was also interpreted to prohibit resale price contracts, and it further supported the rule of law announced in the Miles case.[2]

[1] *Dr. Miles Medical Company* v. *John D. Park and Sons*, 220 U.S. 273, 409 (1911).
[2] *FTC* v. *Beech-Nut Packing Co.*, 257 U.S. 441 (1922).

Following the Miles decision, manufacturers interested in establishing resale price control in interestate commerce usually sought to attain it in one of the following ways:

1. By refusing to sell to dealers who act independently on prices.
2. By selling through sales agencies owned by the manufacturer. Inasmuch as the products are sold in its own branches, a manufacturer is able to exercise complete control over resale prices.
3. By shipping goods to dealers on consignment. In consignment selling, an owner transfers goods to an agent with power to sell but retains title until the goods are sold. A consignor has the legal right to control resale prices if the consignee is in truth an agent.
4. By distributing products through selected (exclusive) dealerships and by making certain stipulations as a condition for granting or maintaining the dealership.

The control of resale prices by refusing to sell to dealers who do not follow suggested prices was given qualified support by the Supreme Court in the Colgate case (1919) (see Chapter 9, pages 194–195). Although this case has been limited by subsequent decisions, it has not been overruled. Manufacturers continue to suggest resale prices, and they continue to announce their refusal to sell to those who do not comply. Buyers, moreover, do not have the right to compel manufacturers to sell for cash. As a practical matter, therefore, distributors have little incentive to protest a plan of suggested prices if they want to get the products of a particular seller.

THE LEGALIZATION OF RESALE PRICE MAINTENANCE

Refusal to sell enables a manufacturer to exercise a considerable degree of control over the resale prices of their distributors (wholesalers). In the case of retail trade, however, the number of retailers makes it difficult for most manufacturers to deal *directly* with them. Competition at the retail level has always been difficult to control because of the large number of independent sellers involved. Experience with resale price control, however, had shown that identical retail prices for trademarked products could be secured by means of resale price contracts. Increasingly, therefore, manufacturers of branded merchandise and trade association leaders in the retail field—particularly in drugs—turned their efforts toward securing a legalization of resale price maintenance. Since the economic position of wholesalers is closely related to the profit returns of retailers, they, too, joined in advocating resale price legislation.

The impact of the depression in 1930 and the growth of chain and cut-rate stores offering limited services and lower prices crystallized the efforts of independent retailers and wholesalers into a broad and powerful movement. The approach taken to restrict the competition of chain stores and mail-order houses was that of using price-maintenance contracts drawn by the manufacturers of trademarked articles. A large number of the items sold at retail are trademarked; and increasingly it was realized that if resale price maintenance could be legalized, a considerable amount of price competition could be restricted at the retail level.

The first of the new fair-trade acts was passed by the California legislature in 1931 and amended in 1933. This statute legalized the use of resale price contracts in intrastate commerce on any commodity (1) "which bears the trade-mark, brand, or name of the producer or owner" and (2) "which is in fair and open competition with commodities of the same general class produced by others." The agreed-upon prices were to prevail at all times, except for (1) closing-out sales, (2) the sale of damaged and deteriorated goods, and (3) the sale of goods by order of a court.

The 1933 amendment to the California statute added the highly significant provision that a single agreement to fix the resale price of a trademarked product is applicable to all other like sellers even though they do not sign a price-maintenance contract. This amendment, which is known as the "nonsigners' clause," makes it possible for a manufacturer to make a resale price agreement with a *single* wholesaler or retailer and thereupon require *all* other wholesalers or retailers in the state to charge the same resale price for the given product. Any distributor having notice of the contractual arrangement and not conforming to the prices so fixed is at once subject to legal suit on the charge of unfair competition and price cutting. The nonsigners' clause made the resale price-control laws a potent and most effective method for bringing about *horizontal* price fixing at the retail level. In view of this fact, the California statute and amendment of 1933 were rapidly adopted by other states at the request and importunity of organized trade groups.

Since the resale price-control laws applied only to intrastate transactions, a powerful organized pressure was put upon Congress to legalize the making of resale price-maintenance contracts in *interstate* commerce. This was an indispensable step in providing for the control of prices at the local level, for most trademarked products are manufactured in one locality and sold throughout the nation. In response to the demands of state and local trade associations, Congress in 1937 enacted the Miller-Tydings Act, amending the Sherman Act to exempt resale price agreements in interstate commerce when commodities are shipped into states in which such contracts are legal. The amendment further declared that the making of resale price contracts shall not be regarded as unfair competition under Section 5 of the Federal Trade Commission Act.

SUPREME COURT SUSTAINS RESALE PRICE MAINTENANCE

The first and leading decision of the Supreme Court on the validity of the state fair-trade acts came in the case of *Old Dearborn Distributing Company* v. *Seagram Distillers Corporation*, decided on December 7, 1936.[3] In the Dearborn and related cases, the Court upheld the validity of the Illinois and California fair-trade laws in their entirety. The effect of the decisions was to bring about an enactment of fair-trade laws in most of the remaining states.

The Dearborn case involved the retail sale of bottled whiskey at prices below those stipulated in a resale price-maintenance contract made under the fair-trade law of Illinois. An important issue was the validity of the "non-signers' clause," which makes a retailer subject to resale price control even though he does not sign a contract. Justice Sutherland, speaking for the Court, found no fault with this provision in the case of a dealer "who has had definite information respecting such contractual restriction and who, with such knowledge, nevertheless proceeds wilfully to resell in disregard of it." Said Justice Sutherland: "Appellants were not obliged to buy." Moreover, the Court stated, the restriction on price applied specifically to the sale of products which were identified by the trademark, brand, or name of the manufacturer, and the aim of the law is to protect this property of the producer.

In the further development of its decision, the Court emphasized that a manufacturer of branded products still retains possession of the trademark and good will even though the commodity has been sold. This fact, the Court stated, gives the trademark owner a continuing interest in the commodity. In the words of the Court, "Appellants own the commodity; they do not own the mark or the good will that the mark symbolizes. And good will is property in a very real sense, injury to which, like injury to any other species of property, is a proper subject for legislation."[4]

APPRAISAL OF THE DEARBORN DECISION

From a public point of view the decision in the Dearborn case has many shortcomings. Although it may be true, in the first place, that a retailer is not obliged to buy a trademarked product, the fact is that most or all of the leading products handled in a given line of business (i.e., those providing

[3] 299 U.S. 183 (1936). Other cases on appeal at the same time were *McNeil* v. *Joseph Triner Corp.*, 299 U.S. 183 (1936) (Illinois); and *Pep Boys, Manny, Moe, and Jack* v. *Pyroil Sales Co.*, and *C. G. Kunsman* v. *Max Factor and Co.*, 299 U.S. 198 (1936) (California).

[4] 299 U.S. 193–194. A retailer (reseller), in principle, may remove the trademarks, brand names, or other marks used to identify the manufacturer, and sell a fair-traded product at any price he chooses.

most of the sales) may be subject to resale price maintenance. Also, the public demand may be such that particular brands must be handled if a retailer is to conduct his business.

Secondly, the Court in its decision emphasized the need of *manufacturers* for legislation to protect the good will embodied in their trademarked products. Actually, the organized drive for resale price legislation came largely from independent retailers and wholesalers who were interested in restricting price competition at the retail level. Available evidence indicates, moreover, that in many cases it is the organized retailers who take the lead and bring pressure on manufacturers to adopt resale price control.

THE COMPLAINTS OF INDEPENDENT RETAILERS

In defending their pleas for resale price-control legislation, retail trade associations raised a cry against the use of leaders and loss leaders by chain stores seeking to increase their sales volume. A *leader* is defined as a product offered for sale at less than its usual or customary price for the purpose of inducing customers to buy it as well as other articles in the seller's shop. In most cases, products used as leaders are advertised, trademarked items, for the quality of such goods is fairly well standardized and consumers are quick to respond to slight variations in price. A *loss leader*, on the other hand, is variously defined as a product which is sold (1) below the net invoice or replacement cost *plus* the average or usual cost of doing business or (2) below the net invoice or replacement cost (also called "laid-down" cost).

Sometimes retail sellers complain that loss leaders are being used when the prices quoted by another seller are below *their* net purchase cost plus *their* average cost of doing business. This is clearly a fallacious view, for the average cost of any given firm may differ substantially from that of other firms. Frequently, the term "loss leader" is also applied to products sold below the particular seller's usual markup. This is likewise fallacious, for the idea of price competition means that a seller will reduce his markup, when necessary, to attract customers. It is also unsound to insist that a given seller apply his average cost of selling all goods to the cost of selling a given line. This view disregards differences in the rate of turnover of the various lines, as well as differences in the cost of selling the various individual lines. *Products sold at less than net invoice or replacement cost are clearly loss leaders.*

The Problem of Sales at Reduced Prices

There is evidence to indicate that a principal problem faced by independent retailers seeking resale price controls was not the problem of loss leaders, as such, but rather that of genuine price competition with chain and limited-service stores. A real problem faced by independents was the fact that chain stores were able to sell products at lower prices because of

the economies of large-scale buying and the offering of limited services in selling.

Injurious Price Discriminations

Although chain and other limited-service stores brought new and socially desirable economies to the merchandising field, their behavior was not, and is not, always fair and socially desirable. Three evils, in particular, exist. First, large retail chains frequently secure discriminatory lower purchase prices. In its special study on chain stores (1934), the Federal Trade Commission reported that the chains had followed a persistent policy of seeking out and demanding special and unwarranted price concessions.[5] The Robinson-Patman Act was enacted in 1936 in an effort to curb injurious quantity-price discriminations. Judicial interpretations, particularly in the Standard Oil of Indiana case (1951), however, have significantly weakened this law (see also Chapter 14, pages 318–320).

A second evil is that of commodity or use discrimination. A well-diversified retailer (selling a wide variety of products) may be in a position to engage in commodity discrimination to injure a seller specializing in one or a few items. The diversified seller may cut prices in a discriminatory way on certain products while making larger profits on other lines in which competition is not active. At the present time, the antitrust laws place no effective restraint on this form of loss-leader selling.

A third unfair practice employed on occasion by the large retail chains was, and still is, that of *geographic* price discrimination. Instead of reducing prices uniformly in all its locally separate stores, a large chain sometimes cuts prices only in certain regions or communities in which the competition of independents is especially active. It was this evil which Congress sought to curb in the Clayton Act of 1914 and the Robinson-Patman Act of 1936. Important decisions, notably the Standard Oil of Indiana decision (1951), however, now largely prevent the effective enforcement of this part of our public policy.

The Federal Trade Commission stated in its final report on chain stores:

> Chains frequently sell the same quality goods at the same time at different prices in their various stores. This manifests itself in the form of leaders and so-called "loss leaders" at some stores, in the pricing of private brands, and in differences between the headquarters' price and the branch-store price on many articles. *The ability of chain stores to vary prices among their different branches and thus to average their profit results is one of their chief advantages over independents.* In other words, it is one of the chief elements in the growth of chain-store systems to their present dimensions and there is no ground for expecting a different effect upon their future growth. This

[5] Federal Trade Commission, *Final Report on the Chain Store Investigation,* 74th Congress, first session, Senate Document 4, 1935, pp. 24–28, 57.

means that chain-store systems will probably continue to increase in size and tend more and more toward a monopolistic position.[6]

Local price cutting by large chains to advance their position continues to be a serious problem for small business. On June 3, 1957, Safeway Stores pleaded *nolo contendere* to a Sherman Act charge that it had started price wars in selected cities for the purpose of destroying competition. In such local price-war areas, it was alleged, Safeway operated its stores below the cost of doing business. The court imposed a fine of $105,000 on Safeway Stores, $7500 on a former president, and $7500 on a division manager.

THE APPLICATION OF RESALE PRICE MAINTENANCE

The principal fields in which fair trade is important are the following:

- Automotive parts and accessories
- Alcoholic beverages
- Books, music, and publishing
- Clothing and wearing apparel
- Cosmetics
- Drugs
- Electrical appliances
- Gasoline
- Home furnishings
- Housewares, hardware, and paint
- Jewelry, watches, and silverware
- Photographic supplies
- Stationery and office supplies
- Textiles
- Tobacco and smoking accessories
- Toys and sporting goods

In the main, resale price maintenance is successfully applied in the sale of brand-name products which are highly advertised, nonperishable, and widely distributed. A further condition for the fair trading of a particular product is that most, or nearly all, manufacturers of widely used branded products which are close substitutes join in making fair-trade contracts with their distributors. If one large-scale drug manufacturer, for example, sets a fair-trade price on his nationally advertised ammoniated toothpaste and another large-scale manufacturer does not, he is clearly at a disadvantage. The maintained price can easily be undermined by lower prices on close substitutes.

There are three important categories of products which do not lend themselves to resale price control. One category includes highly stylized, seasonal merchandise, such as women's dresses. In most cases, manufacturers and retailers alike believe that the pricing of such merchandise should be free in order to insure clearance of seasonal items which are likely to become obsolete during the off-season. A second category consists of high-ticket merchandise which is commonly sold on a trade-in basis. Such products include automobiles, refrigerators, gas and electric ranges, television and radio sets. Experience has shown that resale price control on these items can be evaded by the granting of "excessive" trade-in allowances. A third large category of products which does not lend itself to fair trading includes

[6] Federal Trade Commission, *Final Report on the Chain Store Investigation*, 74th Congress, first session, 1935, pp. 50–51. Italics supplied.

perishable commodities—dairy products, vegetables, and fresh meats. Here, again, flexible pricing is essential in order to insure clearance before spoilage or quality deterioration. In the fresh meat industry, for example, a ruling maxim is "Sell it or smell it."

THE INTEREST OF MANUFACTURERS AND DISTRIBUTORS IN RESALE PRICE CONTROL

A manufacturer finds an interest in maintaining price identity and generous margins for his wholesalers and retailers in order to secure many outlets for his products. Also, when two or more manufacturers of the same class of goods fair trade their products, each is protected against loss of sales to the other because of price competition at the local level. By maintaining local prices, moreover, manufacturers ease the pressure which distributors may exert on them to reduce the mill or factory prices. Higher final prices provide a larger source of profit for each link in the distribution chain.

Organized distributors, usually retailers, frequently press for the establishment of resale price maintenance when manufacturers do not take the lead. Their interest is higher retail markups and price identity.

Resale price arrangements, it appears, are most effectively maintained when (1) the manufacturers of brands which are close substitutes collectively desire to maintain resale prices *and* (2) organized retailers of the few leading brands, which account for most of the business, cooperate in establishing and policing resale price arrangements. In a penetrating study of resale price control, Ward S. Bowman, Jr. concludes: "Favorable conditions for resale price maintenance entail some substantial departure from competitive conditions among both sellers and resellers."[7]

Fair Trade Contracts in Interstate Commerce Declared Unenforceable Against Nonsigners

The effectiveness of resale price contracts was substantially restricted by the Supreme Court in *Schwegmann Bros.* v. *Calvert Distillers Corp.* (1951).[8] Calvert and Seagram, whiskey manufacturers, maintained fair-trade pricing on products which they sold in interstate commerce to dealers in Louisiana. The fair-trade price for "Calvert Reserve" whiskey was $4.37 per fifth, including tax; but Schwegmann Bros., a nonsigner in New Orleans, sold it for $3.25. The Louisiana Fair Trade Act contained the "nonsigner" clause, and Calvert and Seagram brought suit to enjoin Schwegmann Bros. from selling at the lower price.

[7] Ward S. Bowman, Jr., "Resale Price Maintenance—A Monopoly Problem," *The Journal of Business of the University of Chicago*, July, 1952, p. 150.

[8] 341 U.S. 384 (1951).

In defending their low-price policies, Schwegmann contended that the use of the nonsigner clause in interstate commerce violated the Sherman Act. The lower courts rejected this defense, but Schwegmann appealed to the Supreme Court. In a six-to-three decision the Supreme Court upheld Schwegmann and declared that the Miller-Tydings law does not give immunity to nonsigner arrangements. The nonsigner provision, the Court stated, is not in the legislation of 1937. Only voluntary, *signed* resale price contracts, it held, are exempted from the Sherman Act.

The Miller-Tydings amendment was thus construed to apply only to parties *who sign* resale price contracts and not to "nonsigners" who had notice of the fixed prices. Since most branded articles are shipped in interstate commerce, and since most resale price arrangements are based on state nonsigner provisions, the decision struck a serious blow to resale price programs.

A weakening of resale price maintenance also occurred in *Sunbeam Corp. v. Wentling* (1950). This action was brought by Sunbeam against Wentling, a mail-order dealer in Pennsylvania, and a nonsigner, for making sales, intrastate *and interstate*, of Sunbeam electric shavers at less than the price Sunbeam had fixed for Pennsylvania. In its decision, the Court of Appeals denied Sunbeam protection against Wentling in making *interstate sales* at less than the price for Pennsylvania. The Pennsylvania statute, the court said, cannot govern or burden interstate commerce—that is, "sales by Pennsylvania retailers to consumers in other states."[9]

The main effect of the Wentling decision, it appears, was to give a mail-order house in one state, as a nonsigner, the legal right to sell and ship into another state at prices below the locally maintained prices. The Wentling decision gave rise to demands for an amendment to make mail-order operators observe a *fixed* retail price in interstate shipments.

McGUIRE ACT ADDS NONSIGNER CLAUSE TO FEDERAL LAW

Practitioners of resale price maintenance found that the Schwegmann and Wentling decisions were very unsettling. A manufacturer seeking to maintain resale prices thereafter had the task of making and policing individual contracts with the thousands of his retailers in each state. This was much too troublesome in most situations. Local retailers acting in unison also faced the price competition of mail-order houses selling in interstate commerce. Much pressure was accordingly placed upon Congress to amend the Miller-Tydings Act by (1) adding the nonsigner clause and (2) making the resale price agreement established in one state applicable to sales into other states.

As finally adopted by Congress in 1952, the McGuire Act (Public Law

[9] 185 F. (2d) 903, 908 (1950).

542) reverses the Schwegmann and Wentling decisions and makes permissible the use of the nonsigner clause within a given state, in accordance with the legislation of the state, by manufacturers selling in interstate commerce. The Act also authorizes the fixing of minimum or *stipulated* (actual) resale prices. Upon the basis of the McGuire Act, a manufacturer is able to require *all* retailers in a "fair-trading" state to observe the minimum or actual prices which are fixed in a written contract made with *one* retailer in that state.[10]

The McGuire Act also contains a clause designed to remedy the "mail-order loophole" made by the Wentling decision. The Act declares that neither the authorized agreements nor the nonsigner arrangements "shall constitute an unlawful burden or restraint upon, or interference with, [interstate] commerce."

The fight for the McGuire bill was led by the Bureau of Education on Fair Trade, New York City, an organization backed chiefly by such large drug concerns as Bristol-Myers, Coty, McKesson and Robbins, and Eli Lilly and Co.; the American Fair Trade Council, Gary, Indiana, an association of diversified manufacturers; and such trade associations as the National Association of Retail Druggists, the National Association of Chain Drug Stores, and the National Wholesale Druggists Association. Some 1300 local, regional, and national trade associations, it is estimated, supported and fought for the McGuire bill. Vigorous protests of the bill were made by labor, farm, and consumer organizations, but the organized industry groups proved to be the more influential.

NONSIGNER CLAUSE—THE HEART OF FAIR TRADE

In many lines of business, manufacturers distribute their products through wholesalers to thousands of retailers. The great majority of retailers are small, and the only way their wants can be served by a manufacturer is through wholesalers. In all such cases, it is much too difficult for a manufacturer to make and maintain resale price contracts with *every* retailer. It is for this reason that advocates stress the vital importance of the nonsigner clause.

The opponents of fair trade, on the other hand, are equally vigorous in opposing the nonsigner clause. They declare that it is unfair because it binds a person to a contract to which he is not a party. In principle and in practice, all retailers of a given product in one state can be bound by a single fair-trade contract. This, it is alleged, is arbitrary and beyond the present constitutional powers of a state government to permit.

[10] In 1953 the Supreme Court refused to review a Court of Appeals decision upholding the constitutionality of the McGuire and Louisiana Fair Trade Acts (*Schwegmann Bros.* v. *Eli Lilly*, 205 F. [2d] 788 [1953]; certiorari denied, 346 U.S. 856).

PRESENT STATUS ON STATE RESALE PRICE-MAINTENANCE LAWS

Since 1953, a growing number of state fair-trade statutes have been weakened or invalidated by their respective state courts. The states include Arkansas, Colorado, Florida, Georgia, Indiana, Kansas, Kentucky, Louisiana, Michigan, Nebraska, New Mexico, Ohio, Oregon, South Carolina, Utah, Washington, and West Virginia. In these seventeen states, the state courts have condemned the nonsigner's clause and, in a few cases, also the entire statute. The supreme courts of Michigan, Georgia, Washington, and Florida, for example, declared that legislation requiring compliance by nonsigners is "outside the scope of the police powers of the state." The Michigan and Washington state supreme courts declared the nonsigner clause to be unconstitutional because it bears no reasonable relation to public morals, health, safety, or welfare. "The process of reducing prices" by competition, observed the Michigan court, does not bring evils to the general welfare.[11]

The Masters Mail Order decision (1957) also dealt a serious blow to fair-trade enforcement in the fair-trade states. This decision permits a reseller in a nonfair-trade state to sell into a fair-trade state at any price he pleases, regardless of whether the branded product for sale is being fair-traded in the fair-trade state.[12]

In view of the considerable number of states in which the nonsigner's clause is invalid, as well as the Masters Mail Order decision, many prominent fair-trade companies for the time being have abandoned attempts to set minimum retail prices. Their belief in fair trade remains intact, but its weakened status, they find, currently prevents effective enforcement.

FAIR-TRADE PROPONENTS SEEK FEDERAL RESALE PRICE-CONTROL STATUTE

Inasmuch as so many state courts have declared their respective state fair-trade statutes to be imperative, proponents of fair trade have turned

[11] For a summary of the adverse legal decisions, see *Ninth Annual Report,* Select Committee on Small Business, U. S. Senate, 86th Congress, first session, 1959, pp. 60–73. Top state courts upholding the validity of the nonsigner clause include Arizona, California, Connecticut, Delaware, Hawaii, Illinois, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, South Dakota, and Wisconsin. While Tennessee's supreme court has held the Fair Trade Act valid and enforceable, the decision did not involve an interpretation of the nonsigner clause. Lower court decisions in Puerto Rico and Rhode Island have upheld the validity of the nonsigner clause.

[12] *General Electric Co.* v. *Masters Mail Order Co. of Washington, D.C., Inc.,* 244 Fed. (2d) 681, certiorari denied by U. S. Supreme Court, 355, U.S. 824 (1957).

to Congress for a federal statute authorizing the making of resale price-maintenance contracts on products sold in interstate commerce. The position of fair-trade advocates is that a *national* law is a requisite for effective fair trade. A national law is needed, it is said, because there are now so many holes in the national market.

A number of bills have been introduced in Congress to provide for a federally sanctioned system of resale price control. Growing opposition to fair trade, however, has led to the shelving of these bills. Their sponsors have announced that efforts to secure federal fair-trade legislation, including a nonsigner's clause, will be continued.

With fair-trade legislation, enforcement is based upon private suits for damages and upon injunctions to prevent a retailer from selling the fair-traded product at a cut price. Another approach to resale price maintenance is to provide that if a retailer of a brand-name product violates a price schedule established by the manufacturer, the manufacturer shall be legally permitted to refuse to sell him additional supplies. Sponsors of this approach claim that a manufacturer of trademarked products should have the legal right so to control his property—that is, his brand name or trademark. Legislation to provide for resale price maintenance through refusal-to-sell has also been introduced in Congress.

THE CASE FOR AND AGAINST FAIR TRADE

In general, any measure will be found to have advantages and disadvantages. The task of the student is to determine which is dominant. With this point of view in mind, we shall examine the arguments for and against fair trade.

The main issues raised in the discussion of fair trade are the impact of the practice on (1) competition, (2) productive efficiency, (3) unfair practices, (4) protection of brand names, and (5) the level of prices. The arguments in favor of fair trade are those advanced by manufacturers, wholesalers, and retailers who employ resale price maintenance. The arguments against, on the other hand, are those made by persons in the antitrust agencies, by businessmen who oppose fair trade, by various specialists in marketing, and by labor and consumer groups.

The Maintenance of Competition

Case for Fair Trade. Resale price control, its supporters declare, does not eliminate competition, for the price-fixed goods still have the competition of (1) other fair-traded products and (2) nonfair-traded merchandise. Retailers, moreover, continue to vie with one another in rendering service to consumers.

A manufacturer of fair-traded products, it is said, is free to price his lines

as he desires. There is nothing in the law, moreover, which prevents retailers from selling private brands and unbranded merchandise at any price that they desire. Such competition compels manufacturers to establish fair-trade prices which will win customer acceptance, if they wish to sell their products. Fair-trade prices, therefore, are tested for their reasonableness every day in the over-the-counter market to consumers.

The nonsigner clause comes into play as a part of the state's system against unfair competition only if a retailer decides to carry fair-trade products. No retailer is required to carry fair-traded merchandise.

Case Against Fair Trade. Opponents emphasize that price maintenance is a device for preventing price competition at (1) wholesale and (2) retail in the sale of branded merchandise. Under the cloak of this legislation, private persons are given the power to fix prices horizontally, applicable to (1) *all* wholesalers and (2) *all* retailers of the branded merchandise in a given state. If such action were taken directly, it would be illegal. However, when it is taken under resale price legislation, it is legal *and* enforceable by the courts!

The power to fix the resale prices of a branded product, sold by many independent retailers, is entrusted to a private seller engaged in serving his own pecuniary interests. The price so fixed is not subject to change or review for fairness by any retailer. It may be arbitrary or extortionate. Sellers not a party to fair-trade contracts are legally bound to observe the price, regardless of their own costs, methods of doing business, or business efficiency.

In industries dominated by three or four large manufacturing firms, there is a tendency for the various firms to "peg" their factory prices at levels comparable to those of the leader and to use zone or basing-point pricing. If and when these firms make resale price agreements with their local dealers, price competition is eliminated all the way through to the final consumers. The view that resale price maintenance transfers price competition from retailers to manufacturers is largely illusory.

Productive Efficiency

Case for Fair Trade. Fair trade contributes to an orderly marketing mechanism through which the public can enjoy the benefits of mass production. The fixing of adequate margins of profit makes it possible for many small retailers to remain in business. This provides a manufacturer with a larger number of retail outlets and assures him of the widest possible distribution for his products. No manufacturer can afford to price his product for the convenience of the inefficient distributors because he would price himself out of the market.

Resale price contracts also serve to prevent economic concentration in the retail field. Large chain stores usually have lower costs or lower cost-prices;

and if open price competition were permitted, many small retail stores would be eliminated.

Case Against Fair Trade. Resale price maintenance ignores the factor of productive efficiency. In seeking to maintain widespread distribution for his products, a manufacturer sets markups which operate to permit many high-cost and inefficient distributors to stay in business. These fixed and arbitrary markups must thereupon be used regardless of a seller's efficiency, scale of operations, method of merchandising, or type of service rendered. The "proper" *retail* margin for a specific product should be determined by the free play of competitive forces, not by the authoritarian judgment of a manufacturer far removed from the retail business.

With fixed prices, a retailer finds an incentive to increase his outlays—newspaper advertising, radio and television programs, elegant store furnishings, and expensive displays—in an effort to stimulate buying. Resale price maintenance is thus an antiefficiency measure. It promotes cost-raising methods of selling and denies consumers the benefits of lower costs and more efficient ways of doing business.

Unfair Practices

Case for Fair Trade. Resale price maintenance provides small retailers with protection against the price-juggling and price-cutting activities of large retailers. Large retailers commonly use leaders to build up their business and lure customers to their stores. Since low prices are quoted on the featured merchandise, the public is led to believe that prices are also low on all other items, branded as well as private and unbranded. Many small firms specialize in branded merchandise. They cannot afford to use loss leaders, for their volume of business is small.

A retailer's *gross margin* is an over-all *average* which he finds he needs to pay operating costs and make a reasonable profit. Some products carry a higher markup than the average, and some carry a lower markup. The practice of certain chains and giant retailers is to use a low markup on popular branded merchandise and a high markup on other products. This gives them customer good will and much free advertising. Independent retailers cannot compete with this sort of unfair price juggling.

Large retail outlets—chain stores and department stores—on some occasions, and in certain areas, also engage in prolonged selling at below-cost prices. When a local store cannot make up its losses in other departments, or in other areas, it is forced to close. Independent businessmen have found no adequate remedy for the evils of price juggling except the practice of resale price maintenance.

Case Against Fair Trade. The principal competitive evils which confront independent merchants are (1) sales below net invoice cost at the buyer's

place of business (true loss-leader selling); (2) geographic price discrimination; and (3) personal discrimination—i.e., lower cost prices granted to large distributors. The sound way to remedy these evils is to approach them directly by strengthening the laws against price discrimination.

The widespread use of resale price maintenance is likely to bring more evils for independent retailers than those which it seeks to remedy. With a scheme of artificial pricing, competition is often forced underground. The growth of "discount houses" providing little or no service, but offering discounts of 15 to 40 percent, undoubtedly has been promoted by the practice of fair trade. Mail-order houses, chain stores, and big department stores also have introduced their own private brands for use in underselling the fair-trade items. In some cases, efficient retailers who can afford to sell for less than the fair-trade markup use the high profit margins on fair-trade items to offset price reductions on other products. The fair-trade practice thus makes it possible to subsidize the sales of other merchandise to the detriment and injury of independents who do not carry private brands.

Fair-trade pricing brings a further problem in restricting the independence of retailers. In surrendering the right to determine his own margins and asking prices, a retailer becomes a mere outlet for a large manufacturer. A significant aspect of freedom of enterprise is gone—the freedom to manage the inner workings of one's own enterprise. Instead of being subject to planning by government, which business deplores, many thousands of small retailers are now, in fact, subject to planning by big business.

Protection of Brand Names

Case for Fair Trade. Retail price maintenance helps to protect the reputation of branded goods which are highly advertised. Advertising builds a halo around a product and creates an added value which manufacturers seek to maintain. This prestige value can be injured or destroyed by loss-leader selling.

Selling at reduced prices is injurious because substantial variations from the usual price cause buyers to suspect that the quality of the product has deteriorated or that the product has been cheapened. As a result, the public loses confidence and respect for the product. The public also becomes confused as to what is a fair price to pay. At the same time, many retailers find that they cannot make a reasonable profit in meeting the lower prices of other retailers, and their selling energies are thereupon devoted to products having a higher markup. Loss-leader selling thus works to the injury of manufacturers who have secured brand acceptance through years of intensive advertising.

Case Against Fair Trade. There is no sound reason for giving branded goods special protection (1) against price competition at the retail level and

(2) against variations in retail markups, reflecting differences in productive efficiency, methods of merchandising, and services rendered. The lawful purpose of a brand is to permit an owner to identify his product and to show ownership or origin. Our laws now provide adequate protection against the infringement, substitution, or illegal use of such trademarks. Once the legitimate purpose of trademarks has been served, the owners of trademarks should take their place with others in the competitive market.

Loss-leader selling may be an evil in the case of branded merchandise, as well as in the case of unbranded products. In formulating remedial measures, consideration should be centered on the problem of unfair competition, as such. Resale price maintenance, which restricts *all* price competition, fair and unfair, is not a desirable method for controlling loss leaders.

There is little if any evidence to indicate that low retail prices on branded merchandise injure the manufacture-consumer relationship. The damage which a manufacturer fears is the possibility that high-profit retailers will boycott his products if competing retailers sell them at low prices. Experienced merchandisers state, however, that manufacturers can usually overcome such boycotts if they have patience. The strong consumer demand for branded products can usually be expected to change the boycotting policies of high-profit retailers.

The Level of Prices—A "Battle of the Surveys"

Case for Fair Trade. Resale price maintenance makes for prices which are fair and stable. The objective of a manufacturer in fixing resale prices is to provide dealers with a fair markup to cover expenses and leave a net profit. Both unduly low and unduly high prices are prevented. Numerous price surveys show that (1) fair-trade prices have a better record in resisting inflation than nonfair-trade merchandise and (2) fair-trade prices on certain national brands are actually lower in fair-trade states than in nonfair-trade states.[13]

In a very real sense, the pay-off to the consumer is in the overall prices of a particular store in which he shops, rather than in the prices of a few, selected items. There is no reported instance of a single retail store-wide markup—the average overall—which is greater because of fair trade or which would be less if fair trade were repealed.

Case Against Fair Trade. A large and growing number of price studies are available for comparing prices in fair-trade and nonfair-trade areas. All of the surveys made *in the populous centers* of (1) fair-trade and (2) nonfair-trade states show that the fair-trade prices *are much higher* than

[13] Price surveys are constantly being made by the sponsors of fair trade. It is suggested that students interested in securing current material on the levels of fair-trade prices write to the Bureau of Education on Fair Trade, New York City 17; and to Quality Brands Associates of America, Inc., Gary 40, Indiana.

prices in nonfair-trade states.[14] In explaining the basis for the higher retail prices in fair-trade states, Mr. J. E. Webb, a retailer in Florida, reports that "the average fair-trade prices are set up for a retail markup of approximately 33⅓ to 50 percent. Our retail store can make a liberal net profit with an 8 percent markup in tobaccos; 13 percent markup in the supermarkets; 15 percent markup in wines and liquors; 18 percent markup in fast turnover drugs and patents."

In some cases, fair-trade prices are set somewhat below the nominal prices printed on the bottles or wrappers. Some druggists in noncompetitive sales areas in nonfair-trade states sell at the printed prices on the bottle or wrapper. By comparing the fair-trade price in New York City with the nonfair-trade price in an old-line drug store in Vermont, it is possible to find examples of prices which are higher in nonfair-trade states. If prices in nonfair-trade states were really higher than in fair-trade states, however, the fair traders should logically demand a repeal of all fair-trade laws!

Fair-trade prices are more rigid and inflexible than competitive prices. During a period of prosperity and business expansion, prices maintained under fair-trade contracts undoubtedly do show greater resistance to inflation. During a period of business recession and depression, however, this same price rigidity serves to aggravate and prolong the depressed conditions. Consumer demand is reduced at the maintained prices, and price reductions are not generally made to stimulate buying.

PROHIBITION OF SALES BELOW COST

Fair-trade laws, we noted, are only permissive, and in some instances retailers are not able to induce manufacturers to "fair-trade" their products. The fair-trade laws, moreover, are applicable only to *branded* merchandise, and in many cases price competition shifts from such products to bulk and unbranded ones. In an effort, therefore, to secure legislation covering all products sold at retail, retail and wholesale trade associations, especially in the grocery field, began about 1938 to turn their efforts to securing the enactment of so-called "unfair-practices" acts or laws prohibiting sales below cost.[15]

The California Unfair Practices Act of 1935 was the first of the minimum

[14] See, for example, *Resale Price Maintenance,* Hearings Before the Antitrust Subcommittee on the Judiciary, House of Representatives, 82nd Congress, second session, Serial 12, 1952, pp. 429–476, as well as the Congressional reports and hearings listed at the end of the present chapter.

[15] Some thirty-two states have adopted statutes prohibiting sales below cost. The states are Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New Jersey, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

markup laws, and it has been widely adopted in some form by many other states. The California "model" legislation applies to any concern doing business within the state. Other state laws apply only to wholesalers and retailers. All of the state laws exempt (1) closing-out or liquidation sales, (2) sales of damaged or deteriorated goods, and (3) sales made upon an order of a court; and most of the laws make exceptions for sales of perishable and seasonable goods.

The principal provision in the unfair-practices acts is the section making it unlawful for any person (1) to sell any article below *his* cost or (2) to give away any article or product, "for the purpose of injuring competitors or destroying competition."

The California and related statutes specifically and carefully define the standard of cost below which any sale is presumed to be illegal. Section 3 of the California act provides: "The term 'cost' . . . as applied to *production* is hereby defined as including the cost of raw materials, labor, and all overhead expenses of the producer; and as applied to *distribution* 'cost' shall mean the invoice or replacement cost, whichever is lower, of the article or product to the distributor or vendor *plus* the cost of doing business by said distributor and vendor" (italics supplied). The terms "overhead expenses" and "cost of doing business," the act provides, shall be "defined as all costs of doing business incurred in the conduct of such business and must include without limitation the following items of expense: labor (including salaries of executives and officers), rent, interest on borrowed capital, depreciation, selling cost, maintenance of equipment, delivery costs, credit losses, all types of licenses, taxes, insurance, and advertising" (see Table 26 for an illustration).

It may be noted that the statute provisions on costs merely prescribe a *minimum* scale of costs which a business firm *must* include. The only interest charge, for example, which a seller is compelled to include is interest on *borrowed* capital. Under these statutes, however, there is no question that a seller *may* include *any costs* which he chooses—such as (1) a "fair profit" to the enterpriser on his invested capital and (2) reasonable salaries for working owners and partners. Whether or not a sale is below cost must be determined in each case by taking into consideration the accounting procedures of the merchant. Any reasonable system of allocating costs may be used.

COST SURVEYS

In order to ascertain the cost of doing business, and also to meet the problem of differences in the costs of various producers, the California model statute provides that cost surveys conducted by an industry group or trade association may be used as *prima facie* evidence of cost. Other statutes require a definite percentage markup—such as 12 percent—over the invoice or

TABLE 26. Estimation of Costs for Complying with a Representative Sales-Below-Cost Statute

1. Cost of merchandise or raw materials (invoice cost plus costs of acquisition and delivery to seller's place of business)	\$12,500
2. "Cost of doing business"—also called "operating expenses" or "overhead expenses." This includes:	\$7,500
1. Rent paid to others	
2. Salaries and wages	
3. Depreciation	
4. Taxes	
5. Bad accounts	
6. Allowances for theft, spoilage, etc.	
7. Supplies—paper, twine, etc.	
8. Advertising	
9. Delivery costs	
10. Heat, light, power	
11. Donations	
12. Insurance	
13. Repairs on equipment	
14. Interest paid to others	
15. Telephone, telegraph, and postage expense	
3. Business or accounting costs	\$20,000[a]

[a] Estimation of business or accounting costs. If estimated sales are 20,000 units, the per unit "accounting cost" is \$1.00. Any sale below \$1.00 is, presumably, "a sale below cost." Business or accounting costs, it should be noted, do not include (1) a "fair profit" to the owners on their invested capital or (2) reasonable salaries to owner-managers in the case of individual proprietorships and partnerships.

replacement cost, and provide that any sale at less than such a figure is *prima facie* a sale below cost. *Prima facie* means "at first view"; and in sales-below-cost legislation it means that any person selling for less than the cost estimated by an industry survey or by the percentage markup specified in the law loses his case unless he can prove to the court that his costs are actually lower.

The Montana statute specifically empowers a state commission to establish cost surveys whenever a request is made by ten or more persons. Such cost surveys are deemed to be "competent evidence" in proving the costs of any person complained against under the act. In making a cost survey, moreover, the commission is given authority to issue subpoenas and to secure any desired books, records, correspondence, documents, or other evidence from any person being investigated. The Montana statute is generally regarded by business groups as being a particularly effective and really enforceable type of statute.

ENFORCEMENT OF UNFAIR-PRACTICES ACTS

The time, legal expense, and trouble involved in a possible court case is usually sufficient to bring about a considerable degree of compliance with the prices fixed by trade association groups or with the markups specified by law. Three methods of enforcement are provided, however, to bring

possible recalcitrants into line. First, it is usually provided that any person may take action to enjoin violations of the act. The California act specifically states that any person or trade association may bring such action without even alleging or proving actual damages. If a person, or trade group, believes that he has been damaged, he can also sue to recover damages in addition. Secondly, provision is sometimes made for the bringing of criminal actions against violators. The California and related statutes, for example, provide that any person violating the act is guilty of a misdemeanor for each violation and is subject to a fine ranging from $100 to $1000 and imprisonment for not more than six months. Thirdly, the laws typically provide that action against violators can be brought by the state attorney general or by the county prosecuting attorney.

In most cases, state authorities do not have the necessary funds for initiating cases under the unfair-practices acts. The task of collecting evidence, making cost surveys, and selecting concerns to be prosecuted, therefore, is generally undertaken by interested trade groups. When a case is originated by a dealer or trade group, the state authorities, however, will usually serve as a prosecuting agency.

In order to meet the difficulty of proving "intent" to injure competitors in selling below cost, some statutes provide that a sale below cost is evidence of unlawful intent. Others provide that a sale below cost itself is evidence of a violation. The California and Washington statutes, on the other hand, provide that in any action "proof of one or more acts of selling or giving away any article or product below cost . . . together with proof of the injurious effect of such acts, shall be presumptive evidence of the purpose or intent to injure competitors or destroy competition."

APPLICATION OF UNFAIR-PRACTICES ACTS BY STATE AND LOCAL TRADE ASSOCIATIONS

Although the unfair-practices laws prohibit *a person* from selling below *his* cost, their actual application is typically based upon cost surveys and markup estimates prepared by local and state retail and wholesale trade associations. Indeed, a principal function of some retail and wholesale trade associations has become (1) that of determining the legal standard for prices in an application of the unfair-practices acts and (2) that of policing local and state industry groups to insure that the "legal" prices are fully observed.

If a violation is found, the retailer concerned is contacted by a trade association executive and encouraged in a friendly way to observe "the law." If, however, any resistance is shown, the retailer complained against is told firmly to "get in line or else." A continued violation brings a citation from the office of the prosecuting attorney. The prospect of an expensive legal suit with the probable need to employ expert witnesses on cost may be sufficient to bring about compliance.

In most instances, trade association executives seek to bring about an observance of legal prices by persuasion rather than by legal enforcement. Trade leaders also are reluctant to press for vigorous court action because they fear that the unfair-practices legislation may be tossed out of court as a price-fixing measure. Many states have constitutional provisions against monopolistic activity, and there is also the possibility that interstate commerce may be involved.

LEGALITY OF STATE LAWS PROHIBITING SALES BELOW COST

In California, Colorado, Montana, Tennessee, Wyoming, and Washington the state courts have upheld the respective state acts as a valid exercise of the police power to protect the public welfare. An indication of the general line of reasoning adopted by the state courts in these cases may be found in a decision of the California Supreme Court. The California case was brought especially to test the validity of the California Unfair Practices Act. The Court was presented with an agreed-upon set of facts in which the defendant freely admitted that he had sold tobacco products for less than cost *to injure his competitors*. The only issue before the state Supreme Court was the constitutionality of the law. The Court upheld the statute as a legitimate exercise of the state's police power.

The Oklahoma statute of 1949, prohibiting retail sales at less than cost *with the intent* of injuring and preventing fair competition, was upheld by the Supreme Court of Oklahoma in 1951. The validity of the Oklahoma statute was also upheld by the U.S. Supreme Court in 1959 in the case of *Safeway Stores* v. *Oklahoma Retail Grocers Assn.*, 360 U.S. 334. In this case Safeway deliberately and knowingly sold below cost to meet the below-cost prices of its competitors. The U.S. Supreme Court upheld the Oklahoma statute and declared that Safeway should have sought to invoke the Oklahoma statute against its competitors, rather than to have used retaliation.

The unfair-practices acts are inoperative in the states of Ohio, Michigan, and New Jersey, because of adverse rulings by the state courts. The Ohio law was invalidated because it was found to have a tendency to result in identical prices, and the Michigan act was held to be invalid because of the vagueness of the statute in defining cost. In New Jersey the unfair-practices act was declared to be illegal on the ground that its provisions were too uncertain and too indefinite to enable a person to know exactly the lawful course which he should pursue. The Court also indicated that it was exceedingly reluctant to see any restriction placed on the common-law right of buyers and sellers to establish prices by free bargaining.[16]

[16] *Serrer* v. *Cigarette Service Co.*, 74 N.E. (2d) 853 (1947); and *State* v. *Packard-Bamberger and Co.*, 8 Atl. (2d) 293 (1939).

THE UNFAIR-PRACTICES ACTS AND THE SHERMAN ANTITRUST LAW

In view of the widespread evidence that the unfair-practices acts were being applied and made operative by means of collective action, the federal Antitrust Division in 1941 brought charges of collusive price fixing against numerous wholesale and retail groups in various parts of the country. Some nine cases were brought, and in them it was charged that the defendants had violated the Sherman Act in agreeing upon markups and prices, both at wholesale and at retail, in the conduct of business which affected interstate commerce. Most of the cases were settled by the entry of pleas of *nolo contendere*. In several instances, judgments were also entered enjoining the practices attacked.[17]

DO UNFAIR-PRACTICES ACTS PROVIDE PROTECTION AGAINST TRUE LOSS-LEADER SELLING?

An independent retailer frequently finds himself faced with a competitor who is selling a particular product—such as shortening or bananas—at less than acquisition cost. Or, he may be troubled by a competitor who is giving away merchandise, by drawings, contests, or tie-in arrangements. Do the unfair-practices acts provide a retailer with protection against these kinds of unfair competition? The answer is largely "no."

If a sale is found to be below cost (or if a product is being given away), that fact alone does not usually constitute a violation of the acts. There is the further requirement that the sale or gift was made *with the intent to injure and destroy competition*. The sale or gift, in and of itself, does not constitute proof of such intent. Additional evidence must be presented to show a predatory motive. Experience has shown that the task of proving "illegal intent" in such cases is exceedingly difficult. Sellers alleged "good faith" to meet or beat competition; and in the absence of letters or declarations that "I am going to eliminate you," there is no ready way to identify "bad faith."

In 1959 the attorney general for the state of Minnesota reported that during the past two years his office had commenced approximately 200 cases under the state sales-below-cost statute. Effective relief, however, could not be secured because of difficulty in proving intent to injure competitors arising out of particular sales below cost.

[17] See, for example, *Food and Grocery Bureau of Southern California* v. *U.S.*, 139 F. (2d) 973-975 (1943); and *California Retail Grocers and Merchants Association* v *U.S.*, 139 F. (2d) 978-983 (1943).

THE NEED TO STRENGTHEN PRESENT LEGISLATION AGAINST PRICE DISCRIMINATION

Resale price maintenance and sales-below-cost statutes are offered by their proponents as a remedy for price cutting and loss-leader selling. A large part of these evils can be traced directly to price discrimination. It follows that the logical approach to take against the evils is that of curbing injurious discrimination.

To what extent do existing state laws against price discrimination provide an adequate remedy? Although most of the states have laws against price discrimination, an injured person cannot expect to secure relief under the state laws, for they permit price discrimination "to meet competition."

Likewise, the Robinson-Patman Act, which requires a seller to treat his customers on equal terms, in fact provides inadequate protection. As interpreted by the Supreme Court, the law permits a dominant seller to discriminate in price, even when the effect is to injure competition, when it can be shown that the seller discriminates in good faith to meet competition. If state and federal laws against price discrimination are to be made effective, it is essential that amendments be adopted declaring that price discrimination is illegal whenever it can be shown that competition, in fact, is thereby injured.

Further, the present antitrust laws place no effective restraints on discriminations in the sale of different products. In the Sears case, for example, the Federal Trade Commission issued an order against the loss-leader selling of sugar by Sears, Roebuck and Co., after finding that Sears was selling sugar at prices below its invoice cost. The Court of Appeals set aside the order, declaring: "We find in the statute no intent on the part of Congress, even if it has the power, to restrain an owner of property from selling it at any price that is acceptable to him or from giving it away."[18] As interpreted by the courts, Section 5 of the Federal Trade Commission Act condemns sales below cost only when they are made *with the intent to injure competition*. In practice, the task of proving "illegal intent" in antitrust cases is very difficult, for a seller can usually allege that he was discriminating (cutting prices) merely to improve his trade position.

As a means of curbing the practice of loss-leader selling, it has been proposed that some limit or restraint be placed on this kind of discrimination, particularly at the retail level, without reference to meeting competition or to "intent to injure competition." The proposal is that the antitrust laws be amended to make it illegal "to discriminate between or among different commodities or similar commodities of different grade and quality *by reselling at retail* in or affecting commerce *any commodity at less than net cost of such commodity delivered to the retailer's place of business* . . . where the

[18] *Sears, Roebuck and Co.* v. *FTC* 258 F. 307, 312 (1919).

effect . . . may be substantially to lessen competition."[19] Such a law would not specify any particular markup, but it would provide a floor below which prices could not be deliberately cut. An exception, of course, would be made for price reductions to clear seasonal or excessive inventories and distress stocks of merchandise.

PERCENTAGE MARKUPS A MATTER OF INTERNAL BUSINESS POLICY

Proponents of resale price control are unwilling to support an amendment prohibiting sales below a seller's acquisition costs. Under such a law, they declare, any large retailer could feature a well-known national brand at or just above cost, and at the same time overprice other products to make up his loss in gross margin. Small competitors, it is said, would still be faced with unfair price juggling.

In taking the foregoing position, it is implicitly contended that each article sold should bear a percentage markup roughly equivalent to a store's average gross margin. This contention, however, fails to recognize that the markup which a competitive seller *can take* on different items, in terms of what the traffic will bear, varies from store to store, depending upon such factors as the class of trade served, specialties handled, rate of inventory turnover, existing competition, and established reputation. It also fails to recognize that operating costs vary from seller to seller and from product to product, depending upon efficiency, services rendered, location, methods of merchandising, and so forth. In a system of free enterprise, the appropriate markup for particular goods is a problem for the individual business firm. It is a matter of internal business policy.

RESALE PRICE MAINTENANCE IN CANADA

The Combines Investigation Act condemns all agreements and arrangements which restrict competition or fix resale prices "to the detriment or against the interest of the public." Decisions under the law on fair-trade contracts, however, did not establish any clear-cut rules; and resale price-maintenance agreements in Canada grew with impunity in many lines of business.

In 1951 the government became concerned over the growing extent of resale price maintenance and invited the Committee Studying Combines Legislation to develop a report and recommendations on the practice. The Committee invited briefs from all interested parties, held many meetings at

[19] This proposal was presented by Mr. Everette MacIntyre in *Resale Price Fixing*, Hearings Before the Committee on Interstate and Foreign Commerce, United States Senate, 82nd Congress, second session, 1952, pp. 41–42.

which interested persons were given opportunity to discuss and amplify their representations, and made an exhaustive study of the operation of resale price control. In summarizing its investigations, the Committee stated that resale price fixing "represents a real and undesirable restriction on competition by private agreement or 'law' and its general tendency is to discourage economic efficiency. . . . In our opinion, the prescription and the enforcement of minimum resale prices must be viewed as manifestations of a restrictive or monopolistic practice which does not promote general welfare." The Committee accordingly recommended that the practice be made illegal.[20]

Following the report of the Combines Committee, the Parliament of Canada, after extensive public hearings by a Joint Committee of the Senate and House of Commons, enacted legislation (December 29, 1951) (1) declaring resale price maintenance to be illegal and (2) making it an offense to refuse to sell, to withdraw a franchise, or to take any other form of action as a means of enforcing minimum resale prices. This legislation stands in sharp contrast to public policy in the United States.

The Canadian government recognizes that loss-leader selling may be a problem in periods of depression. It believes, however, that methods other than resale price maintenance should be employed to remedy the evil.

Resale Price Maintenance, Hearings Before the Antitrust Subcommittee of the Committee on the Judiciary, House of Representatives, 82nd Congress, second session, Serial

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Public Policies Toward Agriculture

Historically, government has sought to promote economic growth and provide for an equitable distribution of income through the institutions of private property, freedom of contract, and competition. With a policy of competition, government does not directly determine the business of production or pricing. It does not participate in the inner workings of a business enterprise. Its duty is rather one of planning the institutional framework within which production, prices, and incomes are determined by the free play of market forces.

It is generally agreed that during times of war and rearmament for defense the exercise of direct governmental control over prices and uses is necessary in order to restrict profiteering, retard the development of inflation, and insure an adequate allocation of supplies for military use. Likewise, most persons would agree that in the case of public utilities—that is, enterprises in some degree characterized by monopoly—direct control is necessary in order to protect consumers against excessive charges. The controversial aspects of price control center on whether or not governmental authority should be used to control the prices and output of certain commodities in order *to improve* the economic position of individuals who produce them.

Direct control fits into our category of price and income determination by *authority*. It means specific action by government to determine, approve, or modify prices, investments, and the use of resources. Government, in some degree, becomes a participant in the making of basic entrepreneurial decisions. In acting directly to control prices or outputs, government may (1) set the minimum, maximum, or actual prices; (2) restrict production or withhold or destroy portions of existing supplies; (3) regulate supply by imposing import and export controls; (4) establish subsidies or bounties to create or protect the domestic production of specific commodities; and (5) grant licenses or permits for new investment or production.

The purpose of the present chapter is to illustrate and discuss the growing use of public control in the American economy, particularly with respect to agriculture. Consideration will first be given to the legal basis for direct

price control in a system based upon competition and "freedom of contract." Attention will then be directed to the policies which government has adopted toward agriculture.

LEGAL BASIS FOR DIRECT PRICE CONTROL IN ANGLO-SAXON LAW

During the Middle Ages, the sparse population and the fewness of sellers in various occupations gave rise to the exercise of direct control by government over the prices and sales policies of various trades—such as those of bakers, millers, tailors, victualers, innkeepers, wharfingers, and ferry operators. In these cases, the small number of sellers—sometimes only one—in a given town or locality frequently resulted in nonservice and the charging of extortionate prices. As a supplement to the policy of competition, therefore, the law imposed the direct obligation on such sellers to serve all customers and to serve them at reasonable rates.

An early legal discussion of the power of government to control directly the prices in various callings is found in a treatise written in 1676 by Lord Matthew Hale, chief justice of the King's Bench of England. Lord Hale wrote that in the regulation of commerce government has the power not only to create markets and prevent forestalling but also to control excessive prices in situations which have a monopoly character. A ferry, for example, operated for the use of all the king's subjects, was declared to be "a thing of public interest and use." The owner of such a ferry was required to serve all who would use it and to charge only reasonable tolls.[1]

EARLY ATTEMPTS TO CONTROL TRANSPORTATION RATES IN THE UNITED STATES

An important factor in the American Revolution was the desire of many business leaders to be free from the restrictions of British mercantilism. The pattern of regulation in the new nation, accordingly, became one which accepted a large measure of freedom in buying, selling, and entry into various lines of business.

The principal occasion for government intervention on price arose with the development of transportation facilities—the turnpike roads, canals, and later the railroads. Conditions of local monopoly usually existed along the various routes, and state governments began to exercise control over monopoly power. The usual procedure was to include in the charters granted to companies for operating turnpike roads and canals a clause requiring the tolls charged to be reasonable. Similar provisions were included in the charters

[1] *De Portibus Maris* (1675), in Francis Hargrave, *Tracts Relative to the Law of England* (London, 1787), pp. 77–78.

and franchises granted to the railroads. These early charter provisions on rates, however, proved to be only "gestures" toward public control. In most cases, the transportation companies, especially the railroads, were active in politics, and their influence on the state legislatures served to prevent any sort of effective regulation.

The economic group which finally came to demand effective government intervention to control railroad rates was the Patrons of Husbandry. This group, popularly known as the Grange, attained a membership of some 750,000 by 1875 and became a new and important factor in American politics. As a result of its influence, "granger laws" were passed in Illinois, Minnesota, Iowa, Wisconsin, and Missouri during the period 1869–1875, subjecting railroad rates to legislative control. The legislation adopted by the state of Illinois in 1871 established maximum rates for freight and passenger service on the railroads, as well as for the storage of grain in public warehouses. The validity of the state regulatory legislation was promptly contested in the courts, and the case involving the Illinois warehouse law of 1871 was the first of the various cases to be appealed to the United States Supreme Court. This was the famous case of *Munn* v. *Illinois*, which was decided by the Supreme Court in 1877 in favor of the state of Illinois.

INTRODUCTION OF THE DOCTRINE "AFFECTED WITH A PUBLIC INTEREST" INTO AMERICAN LAW

In taking steps to enforce the Illinois warehouse law of 1871, the state authorities brought action against Munn and Scott, owners of grain elevators in Chicago, for failure to take out licenses as required by law. Munn and Scott appealed to the courts, claiming that the legislation deprived them of property without due process of law. The Supreme Court of Illinois, however, upheld the legislation on the grounds of public welfare. The owners of the warehouses, it declared, were an "organized combination of monopolists . . . with but one heart, and that palpitating for excessive gains."[2]

The Munn case was thereupon taken to the United States Supreme Court. In upholding the Illinois statute, the Court introduced into American constitutional law the doctrine that direct price control is justified in the case of businesses "affected with a public interest." "Looking, then, to the common law," the Court declared, ". . . we find that when private property is 'affected with a public interest, it ceases to be *juris privati* only.' This was said by Lord Chief Justice Hale more than two hundred years ago." Property, the Court continued, becomes "clothed with a public interest" and subject to public regulation "when used in a manner to make it of public consequence, and affect the community at large." When does the use of property make it of public consequence? The examples cited by the Court indicate that it is primarily when property is used in business activity under

[2] *Munn* v. *People*, 69 Ill. 80, 93 (1873).

conditions which involve some degree of monopoly. It is then that the law imposes on a seller the direct obligation to be reasonable in his terms and to serve all customers.[3]

The decision in the Munn case upholding the legislative determination of maximum rates for grain elevators was applied at once by the Court to the cases which it had pending on railroad rate regulation.[4] "Carriers for hire," the Court found, are likewise "clothed with a public interest" and are subject to public regulation for the common good. In 1884 the "public utility" concept was also applied to companies supplying water. "That it is within the power of the government," the Court declared, "to regulate the prices at which water shall be sold by one who enjoys a virtual monopoly of the sale, we do not doubt."[5]

In 1914 the concept "affected with a public interest" was broadened by the Court in the German Alliance Insurance case. This case involved the legality of an act passed by the Kansas legislature providing for the regulation of fire insurance rates. The Court held that the fire insurance business was one of "public concern." In its opinion the statute served to protect the public against "arbitrary terms" and was thus in accord with the regulation of railroads, street railways, grain elevators, and wayside inns.[6]

RESTRICTING THE DOCTRINE OF DIRECT CONTROL TO CASES IN WHICH MONOPOLY IS "NATURAL" OR INEVITABLE

The broad interpretation placed by the Court upon the phrase "affected with a public interest" in the German Alliance case was subsequently narrowed and limited in its application to businesses usually regarded as "public utilities"—that is, those in which monopoly had come to be accepted as being "natural" or inevitable because of technical conditions. Thus, in the Wolff Packing case, decided in 1923, the Court held that an act of the Kansas legislature providing for compulsory arbitration and the fixing of wages by government was invalid as applied to the food, clothing, and fuel industries. In the case at hand, the Court found that the Wolff Packing Company, which was engaged in the preparation of meat products, was "in active competition" with other meat packers. "It has never been supposed," the Court declared, "since the adoption of the Constitution, that the business of the butcher, or the baker, the tailor, the woodchopper, the mining operator, or the miner was clothed with such a public interest that the price of his product or his wages could be fixed by state regulation." If the "public interest" doctrine could be extended by the legislature to any industry at will, said

[3] *Munn* v. *Illinois*, 94 U.S. 113 (1877).

[4] *Chicago, Burlington and Quincy R.R.* v. *Iowa*, 94 U.S. 155 (1877), and *Peik* v. *Chicago and Northwestern Railway*, 94 U.S. 164 (1877).

[5] *Spring Valley Water Works* v. *Schottler*, 110 U.S. 347, 354 (1884).

[6] *German Alliance Insurance Co.* v. *Lewis*, 233 U.S. 389, 416-417 (1914).

the Court, "there must be a revolution in the relation of government to general business. . . . It will be impossible to reconcile such result with the freedom of contract and of labor secured by the Fourteenth Amendment."[7]

In four subsequent cases the Court by majority opinion refused to extend the "public interest" doctrine to industries which are outside of the narrow concept of public utilities.[8] In taking this position, the view of the Court was that "freedom of contract" provides for a regulation of price by means of competition. It was primarily when monopoly is found to be "natural" or inevitable that the Court recognized the need for direct control and read into the Constitution the common-law doctrine that the public is entitled to protection against arbitrary and unreasonable prices.

JUDICIAL ACCEPTANCE OF PRICE CONTROL BY AUTHORITY FOR PURPOSES OTHER THAN THE REGULATION OF MONOPOLY

The action taken by the Supreme Court in limiting the "public interest" doctrine to businesses in which monopoly is generally recognized as being inevitable was sharply and abruptly modified in 1934 in *Nebbia* v. *New York*.[9] This case involved the legality of a New York statute providing for the control of milk prices at retail by a state board. The purpose of the legislation was to *increase* the incomes of the dairymen.

The retail price of milk in New York State was fixed at 9¢ a quart. Leo Nebbia, a grocer in Rochester, sold two quarts of milk and a five-cent loaf of bread for 18¢ and was convicted of violating the law.

The position taken by the attorneys for Mr. Nebbia was that direct legislative fixation of prices violates the freedom of contract guaranteed by the Fourteenth Amendment, except in the case of business "affected with a public interest"—that is, in a narrow category of public utilities. The milk industry, it was contended, had none of these characteristics. Justice Roberts, speaking for the Court, agreed with these contentions, stating: "We may as well say at once that *the dairy industry is not*, in the accepted sense of the phrase, *a public utility*. We think the appellant is also right in asserting that there is in this case no suggestion of any monopoly or monopolistic practice." However, Justice Roberts asked: "If, as must be conceded, the industry is subject to regulation in the public interest, what constitutional principle bars the state from *correcting existing maladjustments by legislation touching prices?* We think there is no such principle."[10]

Upon the basis of this reasoning, a majority of the Court set aside its past

[7] *Wolff Packing Co.* v. *Kansas*, 262 U.S. 523, 537, 539–540 (1923).

[8] *Tyson Bros.* v. *Banton*, 273 U.S. 418, 429 (1927); *Ribnick* v. *McBride*, 277 U.S. 350 (1928); *Williams* v. *Standard Oil Co.*, 278 U.S. 235 (1929); and *New State Ice Co.* v. *Liebmann*, 285 U.S. 262 (1932).

[9] 291 U.S. 502 (1934).

[10] 291 U.S. 531–532. Italics supplied.

decisions and affirmed the power of a state government to *control* prices in a line of business characterized by competition (not monopoly) whenever it is "reasonably necessary" to do so in the public interest. Freedom of contract, it held, must give way to public price fixing if the legislature finds that such is necessary for the public good.

THE FURTHER EXTENSION OF DIRECT PRICE CONTROL

The changed attitude of the Supreme Court with respect to price fixing as announced in the Nebbia case was soon applied to several additional cases. In 1937 the Court, in a five-to-four decision, upheld a statute of the state of Washington fixing minimum wages for women. In reaching its decision, the Court indicated its extreme concern over "the exploitation of a class of workers who are in an unequal position with respect to bargaining power and are thus relatively defenseless against the denial of a living wage." As in the Nebbia case the Court declared its willingness to permit a state to use its police power to determine prices and incomes for the benefit of one group as against another.[11]

Again, in 1941, the Court upheld the Fair Labor Standards Act of 1938, which was enacted by Congress to fix the minimum wages of all employees, except those in certain designated groups, who are engaged in interstate commerce or in producing goods for interstate commerce. The authority for Congress to exercise such price control, the Court held, was to be found in the power of Congress to regulate commerce and to make all laws "necessary and proper" for carrying into effect its delegated powers.[12]

THE PRICE-SUPPORT PROGRAM IN AGRICULTURE

The sharp fall in farm prices in relation to industrial prices which developed soon after 1929 focused attention on the plight of the farmers (Figure 39); and legislation to provide farmers with higher prices and incomes was made an important part of the "New Deal." The original Agricultural Adjustment Act of 1933 passed by Congress to correct the "disparity" between the prices of farm and nonfarm products was held to be unconstitutional in 1936, largely on the ground that farmers were "coerced" to sign contracts to curtail production.[13] The act of 1938, however, was reformulated to meet certain constitutional objections; and a more liberal Court held that the new legislation was a valid exercise of the power of Congress to regulate interstate commerce and to make all laws "necessary and proper" to that end.

[11] *West Coast Hotel Co.* v. *Parrish*, 300 U.S. 379 (1937).
[12] *U.S.* v. *Darby*, 312 U.S. 100 (1941).
[13] *U.S.* v. *Butler*, 297 U.S. 1 (1936).

"Any rule," the Court declared, "which is intended to foster, protect, and conserve that commerce, or to prevent the flow of commerce from working harm to the people of the nation, is within the competence of Congress."[14]

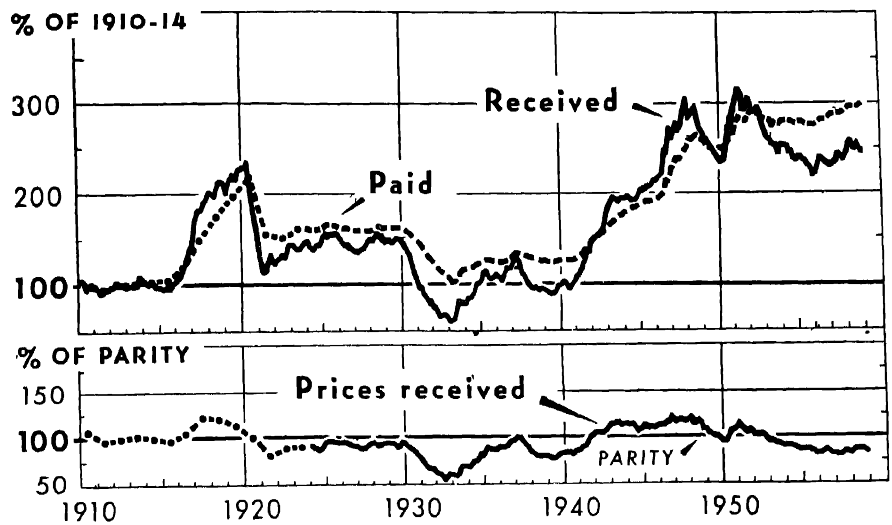

FIGURE 39. Indexes of Prices Received and Paid by Farmers, United States, by Months. The relationship between farm and nonfarm prices existing during the period 1909–1914 was changed during World War I when farm prices rose to higher levels than industrial prices. After 1920, however, farmers not only lost their advantage but experienced a marked disadvantage. (Source: United States Department of Agriculture)

In the Agricultural Adjustment Act of 1938 Congress made provision for (1) the adoption of soil conservation measures, (2) the establishment of production and marketing quotas, and (3) the making of loans on farm products, in an effort to bring the prices of various agricultural products up to a stated percentage of "parity." A parity price in the legislation was defined as that price for a commodity which will give it the same purchasing power (with respect to the articles which farmers buy) that it had during the base period (August 1909 to July 1914). Per-unit price relationships during the five-year period 1909-1914 were considered to be equitable and not subject to the distortions of World War I or the depressed period for agriculture which followed the war. This basic idea of parity price, first enacted in 1933, has been continued to date.

[14] *Mulford* v. *Smith*, 307 U.S. 48 (1939); and *Wickard* v. *Filburn*, 317 U.S. 111 (1942). The act of 1938 covered the "basic commodities of corn, wheat, cotton, rice, tobacco, and peanuts." Mandatory supports, however, were provided only for wheat, corn, cotton, and later peanuts. Additional commodities were placed under price-support programs during World War II.

PROCEDURES USED TO PROVIDE HIGHER PRICES FOR AGRICULTURAL PRODUCTS

In general, it may be said that *higher* prices effected by government control have been secured, and are presently being secured, by (1) providing for a restriction of production to insure the attainment of higher prices; (2) using classified (discriminatory) pricing (as in the case of milk); (3) making loans and purchases to support prices at or near the levels established by law; and (4) paying subsidies to bring incomes up to a more favorable level. Subsidy payments are limited to a very few commodities and are used in lieu of price-support programs.

In most cases, the objective of government in providing higher prices for agricultural products has been, and presently is, to stabilize such prices in relation to but not necessarily at the same level as the prices maintained and secured for commodities and services which farmers buy. Since 200 bushels of wheat would buy a mowing machine in the period of 1909–1914, it is reasoned that 200 bushels of wheat should have a price which will give it the same purchasing power today. The desired objective is not competitive worth, but rather prices in line with those in industry—and, in many cases, managed or administered by industry itself. Quantities of a commodity which cannot be sold at "support prices," or at given percentages of parity, are considered to be surplus. A surplus is usually defined as that quantity which cannot be sold at prices which producers believe to be fair or reasonable.

In its efforts to achieve the objective of agricultural prices which bear a close parity with industrial prices, the federal government adopted the principle of creating *artificial* scarcity. Beginning in 1933 the production of basic agricultural products was curtailed by government control in amounts ranging up to 40 percent of the production of preceding years. The policy of curbing production to secure higher prices was continued in various degrees until the unprecedented demands for foodstuffs occasioned by World War II temporarily provided "parity prices" without the placing of artificial restrictions on production.

Acreage allotments and marketing quotas were again imposed for a number of crops, beginning with the 1950 season. *Acreage allotments* serve as goals for the amount of production needed for consumption. They may be announced by the Secretary of Agriculture for any commodity. Compliance by individual farmers is voluntary. Cooperation with the program, however, determines eligibility for commodity loans. *Marketing quotas* may be applied only to "basic" commodities. They put teeth into acreage allotments by restricting the amount which individual farmers may sell without penalty. Farmers exceeding their quotas forfeit price-support benefits and are required to pay penalties. Marketing quotas must be approved by two-thirds of the farmers voting in a referendum.

Marketing quotas have been established principally for cotton, wheat, peanuts, rice, and tobacco. In 1954, for example, under the marketing quota program farmers reduced their wheat plantings by some 16 million acres. Farmers planting more than their individual quotas are subject to penalties on the excess production if marketed.

The Agricultural Acts of 1948 and 1949 provided for a modernization of the parity concept. The new formula was designed to maintain the over-all relationship which existed in 1910–1914 between prices received and prices paid by farmers, and at the same time to permit adjustments which had gradually developed among prices of individual commodities to be reflected in the parity price of individual commodities.

The Agricultural Act of 1949 provided *mandatory* price-support operations for cooperating farmers (those who do not knowingly exceed their acreage allotments) producing (1) the six "basic" commodities–corn, cotton, wheat, rice, tobacco, and peanuts–and (2) designated nonbasic agricultural commodities–wool (including mohair), tung nuts, honey, milk, butterfat, and the products of milk and butterfat, at various levels not in excess of 90 percent of parity.

The Agricultural Act of 1958 added *mandatory* price support for barley, grain sorghums, oats, and rye at a level determined by the Secretary of Agriculture to be fair and reasonable in relation to the price-support level for corn. Congress at the same time provided for corn price support at 90 percent of the average price received by farmers during the three immediately preceding years, but not less than 65 percent of parity. For cotton and rice the Agricultural Act of 1958 provided a minimum support level of 65 percent of parity beginning with the 1962 crop. Price supports for other agricultural commodities are permissive. *Present laws are "permanent" (continuous until changed).*

Tobacco is covered by a special provision which provides support at 90 percent of parity as long as farmers approve marketing quotas for their crops. Sugar is covered by special legislation. Many commodities also receive price assistance under various marketing agreements and orders (see Chapter 11, pages 244–249). These include fluid milk, citrus and other fruit, tree nuts, potatoes, and vegetables.

THE FARM PROBLEM

The case for government intervention in the pricing and output of agricultural products rests on the premise that there are, at present, significant differences between agriculture and industry which warrant special treatment. In brief, the major differences between the two are seen to be the following:

1. Prices and outputs in the major industries are now subject to a considerable degree of "management" and "administration" by the large cor-

porations ("price leadership," basing-point and zone systems of pricing and conspiracy). In periods of recession, monopolistic industries tend to peg their prices and restrict production, while competitive industries reduce their prices to provide a selling outlet for normal supplies. Thus, during the period 1929 to 1932, *production in industry* was curtailed by about 50 percent. Prices of some industrial products did not decline at all. Steel prices dropped 15 percent; automobile prices, 13 percent; and industrial prices, generally, 25 percent. *Agricultural production,* on the other hand, was actually increased during the period 1929–1932, and prices fell 56 percent (see also Figure 11, p. 117). Farmers, acting by themselves, cannot manage prices and output because they are too numerous. The result is that during periods of recession, farmers are caught in a serious price-cost squeeze. Farm prices decline sharply, but farm costs do not. Agricultural output is maintained, but industrial output is sharply curtailed.

2. Agricultural products, on their way to the ultimate consumers, flow through various processing, fabricating, handling, warehousing, and transporting industries. Ineffective competition at any given stage of productive activity will increase the toll at that point and decrease the amounts which remain for the firsthand producers. Farm spokesmen declare that the small size of most farm units and the limited bargaining power of farmers make it necessary for farmers to secure governmental assistance in marketing.

3. Many farm groups, especially those producing wheat, cotton, rice, and flue-cured tobacco, are particularly subject to the changing demands of foreign nations. Some protection against serious price declines is needed.

An important problem today is one of making it possible for foreign nations, most of which continue to need additional foods and fibers, to earn dollars by selling their minerals, oil, and specialty items in the United States. Farmers have a big stake in the creation of a freer system of trade. Unless foreign outlets are expanded, farmers face the prospect of making substantial reductions in domestic production.

4. Agricultural production is a high-risk industry. The size of a farmer's crop depends not only upon his own efforts, but also upon weather and temperature conditions, the amount of rainfall, the timing of rainfall in relation to crop maturity, insect infestation, and plant diseases. The adjustment of production to market conditions also requires longer periods of time than in other industry. Many crops require a year for their production. The expansion of some, such as livestock, requires several years. Other crops, such as fruit and nuts, can be increased only within a period of eight to ten years. Decreases in production likewise frequently impose serious problems. Orchards continue to bear fruit regardless of market conditions; and dairy herds give milk in good times and bad. Farmers are rarely in a position to adjust output to sharp declines in market demand. In recent years farmers have turned increasingly from the use of draft animals and natural fertilizers to the use of tractors, commercial fertilizers, hybrid seeds, chemical pesticides, herbicides, and synthetic feed supplements. Cash outlay costs have

been greatly increased. This has tended to make the farmer much more vulnerable to sharp price declines and to the occurrence of poor harvests.

5. The nation, as a whole, has a vital interest in maintaining the fertility and productiveness of the soil. Under our private-ownership system, individual farmers are the "custodians" of this basic natural resource. If they do not secure adequate incomes in relation to nonfarm groups, they will not be in a position to engage in soil-conserving practices.

THE PROBLEM OF COST-PRICE SQUEEZE

The particular feature of the farm problem which has caused it to have critical national importance is the cost-price squeeze which develops (1) during a period of recession and (2) during the time the economy is operating at or near full capacity (see Figure 40). From an economic point of

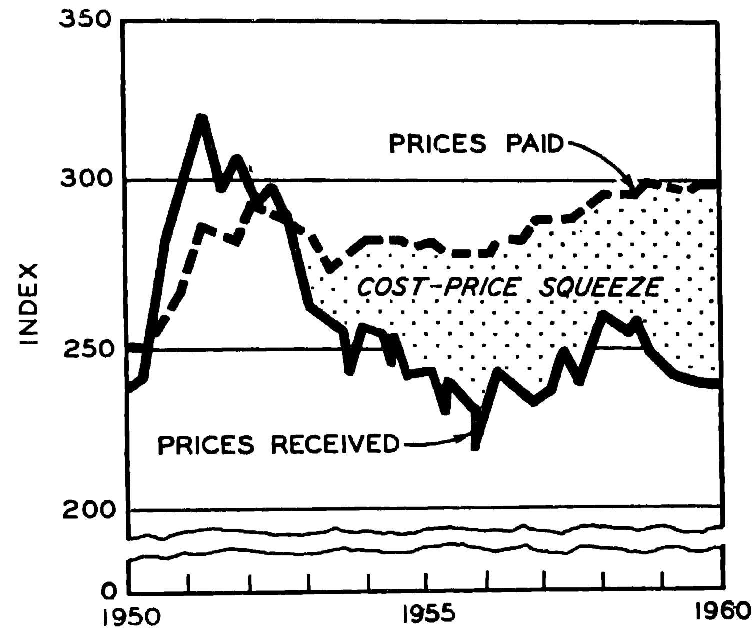

FIGURE 40. Cost-Price Squeeze in Agriculture, 1952–1960. (Source of data: United States Department of Agriculture)

view, it would be sound policy to attack the causes of administered prices in industry which give rise to the disparity problem. This would require vigorous enforcement of the antitrust laws, the outlawing of basing-point and zone systems of pricing, and constructive action to reduce economic concentration. Since it appears unlikely that government in the foreseeable future will adopt vigorous and far-reaching measures to reduce artificial price rigidities in the concentrated industries, the heart of the farm problem

is likely to be with us for many years to come. Both political parties are committed to the practice of price assistance for agricultural commodities, and the question at issue is the form which it should take.

PROGRAMS DESIGNED TO AID FARMERS

Price support and price assistance have been, and continue to be, the cornerstone of the federal farm program. In addition, the federal government provides farmers with farm credit; loans for rural electrification and rural telephone systems; scientific research and development programs; crop insurance; technical aid; rural free delivery of mail; livestock disease control programs; extension work to encourage improved farming and homemaking practices; farm cooperative service to promote cooperative marketing; soil-conserving and water-saving programs; farm-improvement programs (payments for liming, applying superphosphates and other fertilizers, land leveling, and the planting of cover crops); rural development programs; payments to producers of basic crops (except peanuts) for specified percentages of their acreage quotas which they do not plant to these crops but devote to conservation uses (soil bank program); market news reporting on prices and sales; and crop reporting services.

PRESENT-DAY PRICE-ASSISTANCE AND PRICE-SUPPORT PROGRAMS

Price assistance and price support for farm products are provided, in the main, through the following measures:

1. The promotion and encouragement of agricultural marketing cooperatives (see Chapter 11).

2. The Agricultural Marketing Agreement Act of 1937, as amended, which authorizes the use of marketing agreements and orders controlling the sale of enumerated products, including fruit, vegetables, nuts and milk, in interstate commerce. This legislation has three main objectives: (1) to raise prices to "parity" levels, (2) to maintain orderly marketing conditions, and (3) to maintain minimum standards of quality and maturity (see Chapter 11).

3. The purchase of agricultural commodities under Section 32 of the Agricultural Act of 1935, as amended. This legislation authorizes the Secretary of Agriculture to spend an amount equal to 30 percent of the gross import duties collected under the customs for the following purposes:

1. To encourage the export of farm products by the payment of benefits or indemnities.
2. To purchase farm products for use in the school-lunch program; for distribution to low-income groups, hospitals, orphanages, and welfare

agencies; and for diversion programs (e.g., the use of potatoes for starch or for livestock feed).

3. To re-establish farmers' purchasing power by making payments in connection with the normal production of products for domestic use.

Section 32 funds are used for removal of surplus agricultural commodities, thereby strengthening domestic prices. These programs have been used

TABLE 27. Agriculture and Agricultural Resources: Net Budget Expenditures (Millions of Dollars)

	1958 Actual	1959 Estimated
Stabilization of farm prices and income		
Commodity Credit Corporation [a]		
Price support, supply, and purchase programs	987	3,118
Public Law 480	1,073	1,049
National Wool Act	57	21
Soil bank—acreage reserve	620	713
Removal of surplus agricultural commodities (Sec. 32 programs)	125	150
Sugar Act	70	68
Other	42	35
Subtotal	3,151	5,386
Financing rural electrification and telephones	297	325
Financing farm ownership and operation	239	251
Conservation of agricultural land and water resources	448	514
Research and other agricultural services	255	299
Total	4,389	6,775

[a] About 75 percent of the expenditures for agriculture are used for the farm price-support operations of the Commodity Credit Corporation and related price-stabilization programs.
SOURCE: Executive Office of the President, Bureau of the Budget.

largely, particularly in recent years, for perishable commodities such as fruits, vegetables and livestock products for which a storage loan is not feasible. About 15 percent of the more than $2 billion expended under Section 32 since 1936 has been used for making payments to domestic exporters to enable them to sell at the lower prices prevailing in foreign markets.

4. The purchase of agricultural products under the National School Lunch Act of 1946. This legislation authorizes the Department of Agriculture to purchase food for direct distribution to schools and to provide grants-in-aid to the states for use in assisting schools buying food for school lunches. Agricultural products are also made available to schools under Section 32 programs, as noted in the foregoing section.

5. The sale of wheat abroad under the International Wheat Agreement. Thus far, export sales of wheat under this agreement have involved subsidy payments to cover the difference between the domestic price of wheat and the export price.

6. The establishment of quotas on the importation and domestic production of sugar and the payment of subsidies to domestic producers of sugar beets and sugar cane under the Sugar Act of 1948, as amended. In December of each year, the Secretary of Agriculture must determine the amount of

sugar needed to meet the requirements of American consumers during the coming year. Actually, the requirements, or demand, of consumers will depend upon the price of sugar; and in estimating the requirements, the Secretary is directed to have in mind prices which (1) "will not be excessive to consumers" and (2) "will fairly and equitably maintain and protect the welfare of the domestic sugar industry." The actual formulation of such prices inevitably involves much guesswork and compromise.

After the Secretary of Agriculture determines the prospective consumption requirements, he establishes quotas on the basis of a legislative formula for each supplying area—continental United States, Hawaii, Puerto Rico, the Virgin Islands, Cuba, the Philippines, and other foreign countries. Under the terms of the 1948 act, the Secretary is authorized to make subsidy payments to growers of sugar beets and sugar cane in the United States, including Puerto Rico and the Virgin Islands, on condition that they comply with the production quotas, as well as with other provisions specified in the act.

In order to finance the sugar program, the government imposes a special tax of 50¢ per hundred pounds, raw value, on all sugar processed in the United States and on all sugar imported for direct consumption. Subsidy payments to growers, including those in Hawaii, Puerto Rico, and the Virgin Islands, have been running about $60,000,000 per year.

7. The National Wool Act of 1954 declares that it is the policy of Congress to encourage the production of wool in the interest of national security and the general welfare. Wool and sugar are the two principal agricultural commodities in which the United States is deficient in production. We produce only about one-third of our normal requirements of wool.

Each year in the fall an "incentive price" for wool is announced. This is above the free market price. Growers sell their shorn wool in the open market for what it will bring. At the end of the year, when the average price received for wool is known, payments are made to bring the national average price up to the incentive level. Payments are also made to producers in selling lambs with the wool on (pulled wool).

Under the Wool Act, total payments are limited to 70 percent of the duties collected on imports of wool and wool manufacturers. Funds for price assistance are thus related to the duties collected from the protective tariff on wool and wool products.

8. The imposition of import fees and total annual import quotas by Presidential proclamation. Whenever investigations by the Tariff Commission indicate that imports of agricultural products materially interfere with any program undertaken by the Department of Agriculture, the President is authorized to impose import fees not in excess of 50 percent *ad valorem* or such import quotas as he finds to be necessary, except that the quota cannot be lower than 50 percent of the level which prevailed during the period considered representative (Section 22 of the Agricultural Act of 1933, as amended). Under this legislation annual import quotas are currently main-

tained for raw cotton, wheat, wheat flour, filberts, barley, rye, certain cheese and other dairy products, flaxseed, peanuts, and tung nuts and their oils.

9. The provision by Congress of *price-support* programs by which government attempts to establish a "floor" or minimum price for specified agricultural products. This feature of agricultural price assistance is the most controversial part of the total program. The controversy centers on (1) the commodities which are to be made subject to price support, (2) the minimum prices at which government shall extend support, and (3) the extent to which the annual production of designated crops shall be restricted. Commodities covered, price-support levels, and acreage restrictions are likely to shift with changes in economic conditions, as well as with changes in the prevailing political climate. It is suggested that current information on "price floors" and commodities covered be secured by writing to the Department of Agriculture, Washington, D.C.

Price support is achieved primarily through nonrecourse loans and purchase agreements. In some instances, support is provided through purchases and, in the case of wool and mohair, through incentive payments. In the case of a nonrecourse loan, the farmer has the right to redeem the price-support loan by paying off the principal plus interest or to deliver the commodity given as security in full settlement of the loan. In the case of a purchase agreement, the farmer is assured of being able to sell, at his option, not more than the stipulated quantity of a commodity at the support price. Commodities acquired under price-support operations are disposed of in various ways, including domestic and export sales, transfers to other governmental agencies, international barter, and donations for relief use in the United States and also in foreign countries.

The principal mechanism which the federal government has employed in supporting the prices of designated commodities is the Commodity Credit Corporation (created in 1933). This agency seeks to stabilize prices by making loans to farmers or by purchasing commodities at announced support prices. Under the loan operations, if the price of the commodity declines, the farmer keeps the loan money and the government takes the commodity and bears the loss. If, however, the price rises, the farmer is privileged to repay the loan and recover the commodity.

10. The Agricultural Trade Development and Assistance Act, more commonly known as Public Law 480, first became law in 1954 to provide the legal basis for the disposal abroad of United States agricultural surpluses other than those sold for cash and those financed under the mutual security program. In the main, this Act (1) authorizes the export sale of surplus agricultural commodities for the local currency of the purchasing country, (2) authorizes donations of surplus agricultural commodities to friendly peoples in meeting famine or other relief needs, and (3) authorizes the barter of surplus agricultural commodities for strategic and other materials of value to the United States (see also Figure 41).

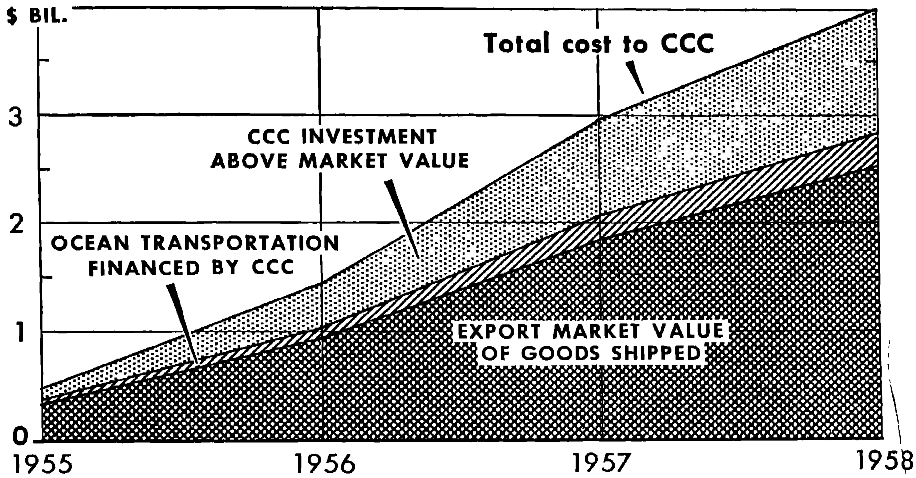

FIGURE 41. Sales Made by the Commodity Credit Corporation Under Public Law 480. These sales are a major factor in United States farm exports. Principal products have been wheat, cotton, fats and oils, feed grains, rice, and tobacco. Products are sold through regular trade channels for foreign currencies, and United States exporters are privileged to exchange these currencies for dollars. The federal government uses the foreign currencies for making loans to the purchasing countries, for military use abroad, for student exchanges, and for other expenses incurred in foreign countries. (Source: United States Department of Agriculture)

SOME CRITICISMS OF PRESENT FARM PROGRAMS

1. Price-support programs in agriculture apply the monopoly principle of creating *artificial* scarcity, as employed by various segments of private industry. They seek to remedy the problem of monopoly by creating more monopoly. An indispensable, *long-run* solution calls for the adoption of measures (antitrust and others) to remedy the problems of rigid prices and restraints on competition as they exist in the industrial and commercial areas of the economy.

A distinguished group of agricultural economists has said: "Since the agricultural depression of the twenties . . . some farmers seem to have adopted a defeatist attitude as to the growth of monopolistic positions in both industry and labor and to have decided to 'fight the devil with fire'. . . . This does not seem to us a sound economic philosophy. . . . Restrictionism in agriculture is not an effective and satisfactory way of compensating for the harm done to farmers by such price maintenance and restriction of production as exist in the industrial and labor segments of the economy." In recommending against acreage allotments, marketing quotas, and related devices to restrict output in agriculture, these economists, "strongly recommend a carefully studied and vigorous attack by farmers, farm organizations,

and farm statesmen upon those restrictionist policies or institutions of business, labor, or other parts of the economy which are designed to enhance the cost of goods or services for which the farmer must exchange his product."[15]

2. Price-assistance programs for farmers seek to maintain the prices of various farm products not only during periods of industrial recession, but also during periods of full-capacity production in industry. Sagging agricultural prices during a period of high-level output in industry may well mean that more producers should move out of agricultural production.

Economists have long frowned upon government intervention to raise or maintain the prices of certain producers above the levels established by the interplay of demand and supply. The *increased income* given to certain groups, they point out, *is secured at the cost of other persons.* The process is simply one of transferring income from consumers to a favored group of producers. Artificially high prices in one segment of the economy also promote a maldistribution of resources. Production is maintained or encouraged without reference to demand, and burdensome surpluses develop which cannot be sold at the fixed prices.

3. The establishment of marketing quotas for designated commodities results in a percentage reduction of operations for each farm unit, whether it is efficient or inefficient and whether its land resources are class 1, 2, 3, or even poorer in quality. From the standpoint of economic efficiency, the goal should be one of getting the greatest results with the least cost. Present farm programs do not have this objective. Governmental policy should encourage the shifting of inferior land into other uses (such as grazing) and the transfer of low-income farmers into other employments.

4. Price assistance programs serve to increase farm income in proportion to output. Owners and operators of large, fertile farms secure substantial cash benefits; whereas those on small farms and inferior land secure minor or zero benefits. Such a plan does not remedy the problem of low incomes which faces many thousands of tenant farmers and farmers with small-sized farms. It is estimated that about one-third of all farms are part-time or subsistence units which can hardly be called commercial enterprises.

ALTERNATIVE MEASURES FOR ENHANCING FARM INCOMES

The Direct-Payment Approach

The incomes of farm families are generally lower than those of nonfarm families.[16] In order to provide a certain minimum level of income for

[15] *Turning the Searchlight on Farm Policy,* The Farm Foundation (Chicago, 1952), pp. 55–57, 65.

[16] According to United States Bureau of Census data for 1955, the median money income of farm families was slightly more than $2100. The median income of nonfarm families was $3700.

farmers as a whole (not individual farmers), it has been proposed that the federal government should make direct payments to farmers to supplement the market price per pound, bushel, or other unit of measure. This plan would be used in place of the parity-price, commodity-by-commodity approach.

A number of agricultural economists believe that the direct-payment plan may be the best procedure to provide an assured, stable income to producers of certain products and to protect farmers, generally, against a serious decline in purchasing power. The present system of supporting farm prices through loans, purchases, and the storage of products provides a marvelous mechanism for *accumulating* farm products. It fails, however, to provide a method for moving them into consumption.

In explanation of the direct-payment plan, Dr. John D. Black, a leading agricultural economist, states:

> The direct-payment plan here analyzed is one that allows all the output, except some diverted to special outlets or to Government stockpiling, to be sold for what it will bring in the market place, and make up the difference between this market price and some support level of price by direct payments to the producers. These direct payments will be referred to hereafter as "deficiency payments."
>
> A reasonably conceived direct-payment plan has much to be said in its favor. First of all, it would be simple to administer. Second, it would call for less direct interference with the trade than most plans. Third, it would help much to stabilize farm incomes and output. Fourth, it would reduce the amounts of products in storage to reasonable proportions.
>
> But to realize most of these advantages, a direct-payment plan will need to be much better conceived than, so far as I know them, is any one that has thus far been offered. . . .[17]

Proponents of the direct-payment method for increasing farm income point out that the federal government has in fact been making substantial payments to farmers since 1933. During the depression years, benefit payments were made for complying with acreage allotments. During World War II, the government paid subsidies to producers of milk and livestock. Currently, producers of wool receive payments under the Wool Act of 1954. Under conservation programs, farmers also presently receive payments for using lime and fertilizers, planting legumes, and building erosion-control structures.

In abandoning the present system of parity-price supports, the government would not buy, or make loans on, commodities. Prices would find a natural level at which the market would be cleared. Domestic and foreign consumption would be increased. The total tax cost of the direct-payment program, moreover, it is estimated, would not exceed present outlays on

[17] *Policy for Commercial Agriculture,* Joint Economic Committee, 85th Congress, first session, 1957, p. 656.

agriculture. Taxpayers, as consumers, would save a portion of this cost in paying lower prices for food.

The Free Market Approach

Some persons contend that if all controls over market supply were gradually eliminated, free market prices would insure a selling outlet and provide a satisfactory income to farmers operating in a businesslike way. Farmers would be free to produce as much of any commodity as they desire, and the federal government would not stand by—as at present—to make loans or purchase commodities to hold prices above the free market level.

It is generally agreed that without federal price-assistance programs, farm prices would be lower. Professor D. Gale Johnson, a leading agricultural economist, for example, states: "There can be no question that if the present farm prices and subsidy programs were abolished the level of farm prices and farm incomes would decline. This would be true even if all stocks held by the Commodity Credit Corporation were destroyed or given to low income countries. There is general agreement that farm output is now larger than can be sold at reasonably satisfactory prices. Currently some 6 to 9 percent of total farm output is passing into government hands through one program or another and is not going into normal market outlets."[18]

If action were taken to move toward a free market policy for agriculture, it is clear that something would have to be done *to reduce* present-day agricultural output. Otherwise, the resulting lower farm incomes would bring serious financial distress.

Professor D. Gale Johnson believes that federal farm programs, particularly during the post-war period, have actually promoted an increased level of farm output. If these programs could be substantially modified or eliminated, he states, farm output would be reduced and a higher level of prices attained through the operation of free market forces.

The particular farm programs which Professor Johnson criticizes are those which increase output through governmental meddling with supply or through governmental favor. Increased outputs arising from new varieties of seed, the control of pests, and the eradication of disease are clearly in the public interest, for they mean more and better goods with less time and effort.

Governmental price-fixing programs inevitably have for their purpose the setting of *higher* prices, for this is the desired goal of organized producers. Higher prices can only be secured by *reducing* market supplies. The resulting surpluses cannot be sold at the pegged prices. This gives rise to accumulated stocks and acute problems of disposal.

With higher, pegged prices farmers have used improved technology and increased amounts of fertilizer, so that surpluses have persisted and grown

[18] D. Gale Johnson, *Agricultural Economic Policy in the United States*, Agricultural Economics Research Paper No. 5827 (University of Chicago, 1958), pp. 4–5.

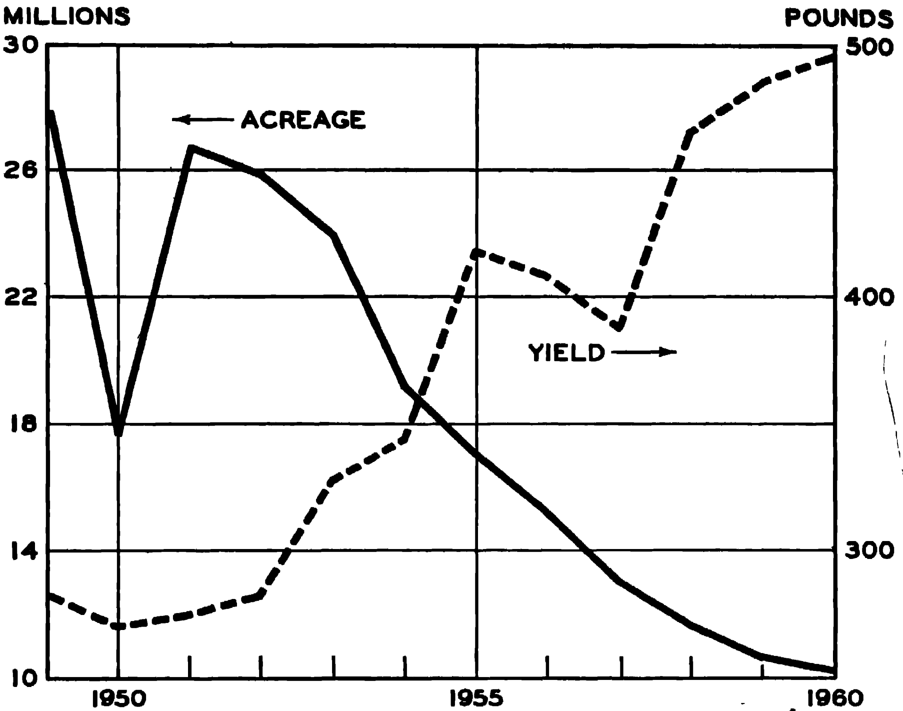

FIGURE 42. Cotton Acreage and Yields. (Source: United States Department of Agriculture)

despite acreage quotas. There is much evidence that for many products production is proving to be increasingly difficult to control. Yields per acre are soon increased to offset acreage restrictions (see also Figure 42).

Price supports, it appears probable, Professor Johnson believes, also tend to encourage larger outputs because they reduce price uncertainty. Farmers are encouraged to make larger plantings.

Additional federal programs which operate to increase farm outputs needlessly, Professor Johnson believes, are new federal irrigation projects; federal programs designed to give farmers financial assistance for liming, the use of fertilizers, land leveling, and the planting of cover crops; and federal sponsoring of arrangements for importing Mexican nationals for seasonal farm work. All of these programs, Professor Johnson believes, should be stopped.

In a positive way, Professor Johnson proposes that the federal government should move over a period of five years to utilize a schedule of price supports which would reduce the support of commodities now being acquired by the Commodity Credit Corporation to levels in line with market forces. Thereupon, he states: "It should be made clear . . . that if price supports were continued their purpose would be to reduce the price uncertainty confronting farmers and to provide for relatively even distribution of the supply of storable products from one year to another."

As a further measure for reducing agricultural output, Professor Johnson states: "We must develop a program to facilitate the transfer of labor from farm to nonfarm occupations. Since 1950 the net migration from farms has been very rapid at an average rate of roughly a million per year. But this rate has not been rapid enough to bring about desirable adjustments in agricultural output and returns to farm labor, especially operator and unpaid family workers."

The free market approach to the farm problem must contend not only with a current agricultural output which is larger than can be sold at satisfactory prices. There is also the factor of monopolistic restrictions in markets for products which farmers buy. These restrictions take the form of administered prices for steel, cement, agricultural machinery, and many other industrial products (see also Chapter 6, pages 115–120).

There is little evidence to indicate that simply moving toward freer product markets in agriculture will improve the economic position of our farmers. The goal of freer markets, however, is basically sound. It should be adopted even though the transition period would be of substantial length. In moving toward this objective, government should also adopt (1) measures designed to bring about a better balance in the demand for and supply of agricultural products and (2) some remedy for the problem of administered prices in the concentrated industries.

Improving the Bargaining Position of Farmers in Local and Central Markets

A problem faced by farmers in many producing areas throughout the country is that of a weak bargaining position in the sale of their crops. In selling directly or through local produce houses, elevators, warehouse buyers, or dealers, the picture is one of a large number of sellers competing with fewer and fewer buyers. Each year mergers in retailing, food distribution, processing, milling, and packing bring a diminishing number of buyers for farm products. The large and growing outputs of farm products, together with a decreasing number of buyers, operate to create a buyers' market for farm products—that is, a situation in which market forces favor the buyers.

Present-day marketing methods also give a sales advantage to processed products which are highly advertised. Sales of soft drinks, candy, tobacco, gelatine desserts, and bakery products, for example, are stimulated by continuous, large-scale advertising. A similar need exists for many agricultural products if they are to hold their place in consumer budgets. This condition is illustrated by the apple industry. During the period 1910–1914, the annual per capita consumption of apples averaged 67.7 pounds; whereas, during the period 1953–1957, only 19.9 pounds were consumed.[10]

In order to strengthen the bargaining position of farmers in various producing areas, it is believed by numerous agricultural marketing experts that

[10] United States Department of Agriculture Bulletin TFC 128, *The Fruit Situation*, August, 1958.

farm groups should increasingly turn to the formation of selling cooperatives. With one or a few cooperative sales agencies in a producing area, working together in pricing and sales promotion, it is believed that returns to growers can be significantly increased. In place of scores of sellers competing against one another, frequently with inadequate market information, there would be a few experienced sellers dealing with the already existing few buyers.

Farm cooperatives, it will be remembered, are exempt from the antitrust laws. It appears, moreover, that two or more cooperatives are privileged to join hands in fixing selling prices (see Chapter 11, pages 237–239). It is also possible for cooperatives to engage in sales promotion campaigns to increase the intensity of demand for their products.

Some agricultural experts, working closely with marketing problems, believe that farmers more and more should turn to self-help arrangements—in the form of sales cooperatives—without relying too much upon direct government action to provide returns more nearly in line with those in other parts of the economy.

21

Methods of Control for Public Utility Enterprises

Public utility enterprises, recognized by the courts as "affected with a public interest," are those in some degree characterized by monopoly. In the case of such enterprises, government accepts monopoly as being natural, inevitable, or desirable, and establishes maximum rates to protect the public against unreasonable and arbitrary charges. What procedures do the various commissions use in keeping down the prices of utility services in the interest of consumers and industrial users? What attitudes have the courts taken with respect to public control to prevent extortion?

THE RULE OF RATE-MAKING IN *MUNN* v. *ILLINOIS*

The power of the legislature to impose price control on public utility enterprises, we have seen, was sanctioned by the Supreme Court in *Munn* v. *Illinois*. In that case the Court also held that the rates so established were not subject to judicial review or revision. "We know," the Court declared, "that this is a power which may be abused; but this is no argument against its existence. For protection against abuses by legislatures the people must resort to the polls, not to the courts."[1]

The rule of rate-making in *Munn* v. *Illinois* was maintained for more than a decade. Repeatedly, however, the railroad utilities were claiming in their litigations that the rates fixed by legislative action were confiscatory and illegal under the Fourteenth Amendment, which provides that no state shall "deprive any person of life, liberty, or property without due process of law." This argument had been presented in the Munn case, but the Court refused to give it application. The Fourteenth Amendment, the Court had earlier held, was enacted to protect the civil rights of the former slaves rather than of corporations.[2] By 1886, however, the Court had brought itself around to accepting the insistent view of railroad attorneys that cor-

[1] *Munn* v. *Illinois*, 94 U.S. 113, 134 (1877).
[2] *Slaughter House Cases*, 16 Wall. 36 (1873).

porations are "persons" within the meaning of the Fourteenth Amendment.[3] In winning judicial review of legislative control, the public utility corporations secured a privilege of tremendous value. Henceforth, they would be entitled to protection in the federal courts against legislative enactments which might adversely affect their economic position.

THE RULE OF *SMYTH* v. *AMES*

In the case of *Smyth* v. *Ames*, decided in 1898, the Supreme Court gave further sanction to its new doctrine that the rates established by government commissions are subject to judicial review. In doing so, the Court reasoned that if the rates established by legislative control do not provide the opportunity of a "fair return" on the "fair value" of the property which is devoted to a public use, there is confiscation of private property. Since corporations had come to be regarded as "persons" within the meaning of the Fourteenth Amendment, it followed, in the view of the Court, that the due process clause of the Constitution requires judicial review of the rates established for public utilities.[4]

In affirming the principle of judicial review for rate making, the Court set forth the rules which it believed should be observed in setting rates. According to Justice Harlan, speaking for the Court,

> We hold . . . that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, *the original cost of construction*, the amount expended in permanent improvements, the amount and market value of its bonds and stock, *the present as compared with the original cost of construction*, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. . . . *What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience.*[5]

Only two of the criteria suggested in *Smyth* v. *Ames* for the determination of "fair value" were found to be useful—namely (1) original cost less

[3] *Santa Clara County* v. *Southern Pacific Railroad*, 118 U.S. 394, 396 (1886). Chief Justice Waite declared, "The Court does not wish to hear the argument on the question whether the provision of the Fourteenth Amendment . . . applies to these corporations. We are all of the opinion that it does." The *Santa Clara* case involved the validity of certain state taxes.

[4] The rule of judicial review is also applicable under the Fifth Amendment to the regulatory activities of the federal government. Both state and national regulatory commissions must approve rates which give a utility a legal right to earn a "fair return" on the "fair value" of its property.

[5] *Smyth* v. *Ames*, 169 U.S. 466, 546–547 (1898). Italics supplied.

depreciation and (2) reproduction cost new less depreciation. Which should be used? If both were used, should favor be given to one rather than to the other? Why? No answers to these questions were given by the Supreme Court, and the efforts of commissions to apply the rule of *Smyth* v. *Ames* gave rise to a continuous and stormy controversy over how the rate base should be determined.

COMMISSION CONTROL WITH JUDICIAL DOMINATION

The rule of rate-making announced in *Smyth* v. *Ames* made it clear that public commissions, consisting of men who make the regulation of utilities their occupation, would have to be created to administer public utility rate-making. Legislatures could not remain in session to apply the legal formulas of rate control and make adjustments in rates with changing economic conditions. The technical difficulties of valuation also required the employment of personnel with special economic and legal training. In consequence, the various state legislatures rapidly took steps to create special commissions. Year by year, moreover, the work of the commissions became more and more complex, for in a series of decisions following *Smyth* v. *Ames* the Supreme Court gave increasing consideration to the appropriateness of the rules followed by the commissions in calculating depreciation, going concern value, operating expenses, and a reasonable rate of return.

The orders made by the commissions were often challenged in the courts by the utility companies on the question of the determination of facts. "Due process of law," it was frequently claimed, required a different set of findings. The courts, in time, accepted the reasonableness of this view and thereupon undertook to examine for themselves the facts and the observance of the rules of rate-making laid down, in particular, by the Supreme Court. As a result, rate-making procedures came to be marked by expensive litigations and prolonged delays.

THE VALUATION OF PROPERTY FOR RATE REGULATION

Growing out of *Smyth* v. *Ames* there were two factors which the Supreme Court repeatedly held should be given appropriate weight by the commissions in approving public utility rates: (1) original cost less depreciation and (2) reproduction cost new less depreciation. The "original cost" procedure finds the appropriate rate base in the dollars which a company has actually invested in the utility presently used and useful, less an allowance for accrued (or total) depreciation. The reproduction cost procedure, on the other hand, finds the proper rate base in the cost of reproducing the specific plant or plants with reference to current prices, less an allowance for accrued depreciation. If the amount resulting from the depreciation

charges is reinvested in productive facilities, it becomes a part of the rate base on which the utility is entitled to earn a "fair return."

Until about 1933, the majority of the Supreme Court accepted the principle of reproduction cost new less accrued depreciation. This method of valuation, it may be noted, was advantageous to owners during the era of rising prices. However, the many administrative difficulties involved in using the reproduction cost procedure, accentuated as they were by the depression, finally caused the Court (as well as public service commissions) to favor the original cost formula, provided the administrative agencies could show that they had given some consideration to present costs. In addition, with a falling level of prices the private utilities were more amendable to original cost in rate base determination.

THE HOPE NATURAL GAS DECISION

A marked change in the regulatory procedure which the courts had followed for years was made by the Supreme Court in 1944 in its decision in the Hope Natural Gas case. Experience with rate-making had long shown the practical difficulties involved in trying to test the fairness of rates upon the basis of cost. In addition to the technical administrative problems of regulation, there were also the many legal problems arising out of the exercise of judicial review by the courts. On the one hand, the commissions were placed in the difficult position of finding their work frequently cast aside by differences in judgment shown by the courts and by changes in the majority view of the Supreme Court. On the other hand, the courts, themselves serving as a final arbiter, were faced with an almost impossible burden of trying to decide whether or not the rates were fair and reasonable.[6]

In the Hope case the Court broke with the procedures of the past and shifted from the principle of judicial domination in the rate-making process to that of administrative domination. The Natural Gas Act of 1938 gave the Federal Power Commission authority to regulate companies selling natural gas at wholesale in interstate commerce. In the exercise of its powers, the Commission ordered the Hope Natural Gas Company to reduce its wholesale rates so as to bring about a reduction of not less than $3,609,857 in its operating revenues. In making this calculation, the Commission used the "actual legitimate cost" of some $33,000,000 as the rate base and allowed a return of 6½ percent on this investment. The company, however, claimed that it should be allowed to earn 8 percent on a cost-of-reproduction rate base of $66,000,000. The Court of Appeals set aside the order of the Com-

[6] By 1933 the Supreme Court began to recognize that it was in no position to substitute its judgment for that of a commission. See, for example, *Los Angeles Gas and Electric Co.* v. *California Commission,* 289 U.S. 287, 304 (1933); and *Federal Power Commission* v. *Natural Gas Pipeline Co.,* 315 U.S. 575, 586 (1942).

mission on the principal grounds that the Commission had failed to consider the current or reproduction cost of the properties. Upon appeal, the Supreme Court in a five-to-three decision reversed the ruling of the Court of Appeals and upheld the order of the Federal Power Commission.

In summary form, the following important points were established by Justice Douglas in the majority opinion in the Hope case:

1. The Court will not review the rate orders of a commission or allow a utility to obtain a review except under the most extraordinary circumstances. In the words of the Court, "The Commission's order . . . is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences."

2. In order to secure a review of a commission's order the utility company must show that the "end result" of the order is unjust because it thwarts the successful operation of the company and restricts its ability to attract necessary capital. "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called 'fair value' rate base."

3. A review will not be allowed because a commission has used one particular method of valuation rather than another. The significant factor is the "end result." "It is not theory," the Court declared, "but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important."

4. The Court recognized the practical difficulty of trying to set rates upon the basis of "costs of production." "Fair value," the Court observed, is the "end product of the process of rate-making not the starting point. . . . The heart of the matter is that rates cannot be made to depend upon 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated." As an alternative to the procedure of trying to set rates which will provide a fair return on the "value" of the property, the Court adopted the principle of examining the "total effect" or "end result" of the rates established by public control.[7]

The Hope case does not mean that a "fair" annual rate of return on the estimated "fair" capital value of a utility is no longer to be used as a criterion of the reasonableness of rates. Representatives of utilities in arguing for higher rates may, and still do, advance the "fair" rate-of-return principle. Under the Hope decision, moreover, it appears that public utility commissions are free to discuss and rely upon "fair return" as one of several tests of whether the "end result" is reasonable. The main meaning of

[7] *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 601–605 (1944).

the Hope decision is, as Professor E. S. Corwin has stated, that "the Court is nowadays disposed to leave the whole business to the regulatory authority, *provided* it affords a fair opportunity to be heard to the interests affected."[8]

The effect of the judicial policy of accepting administrative orders when there is substantial evidence to support them places new and significant responsibilities on the utility commissions. More than ever before, it is important for the commissions to be staffed with well-trained personnel who will make regulation their life career. The added power of control placed in the hands of the commissions is also certain to cause the utility companies to increase their political pressure on the legislatures and executive offices to secure the appointment of commissioners who are sympathetic to the industry and to obtain legislation on regulatory procedures which is advantageous to their economic position.

STATE AND FEDERAL PUBLIC UTILITY COMMISSIONS

Public utility commissions have been established in the District of Columbia and all states except Delaware. In some instances, there is an over-all commission to regulate designated utilities; in other instances, there are a number of special commissions. A state commission is usually called a public service or public utility commission, and its jurisdiction extends to designated utilities which conduct an intrastate business. Utility companies which are engaged in interstate commerce, on the other hand, are subject to control by one of the several commissions or agencies at the federal level. These consist of (1) the Interstate Commerce Commission, (2) the Civil Aeronautics Board, (3) the Secretary of the Army, (4) the Federal Communications Commission, (5) the Secretary of Agriculture, and (6) the Federal Power Commission.

ESSENTIAL FEATURES OF COMMISSION CONTROL

The powers of control exercised by the federal commissions and by many state commissions typically take the following forms:

1. The power to prescribe and require the observance of uniform accounting systems and statistical regulations, including in certain instances prescription of amounts recorded on a utility's books (i.e., the classes of property for which depreciation charges may be included in operating expenses and the percentages of depreciation to be included on such property).
2. The power to establish an appropriate rate base for use in testing the legitimacy of rates and charges.

[8] E. S. Corwin, *The Constitution and What it Means Today* (Princeton, 1958), p. 35.

3. The power to prescribe rates and charges—maximum, minimum, or both—after full opportunity for hearings. Many commissions have authority on their own motion *to initiate* proceedings for rate reductions or for rate increases.

4. The power to control entrance into or abandonment of service.

5. The power to pass upon applications to acquire the ownership or control of another company operating in the same line of business (see also Table 2, pages 46–47).

Upon the basis of the foregoing powers, it may be seen that the approach taken by a commission in controlling the rates of public utilities is that of (1) prescribing uniform systems of accounts and records, (2) scrutinizing and in some cases reviewing certain expenses incurred, and (3) approving or disapproving rates and charges in the light of the earnings which the records reveal.

The basic reasons underlying commission control are (1) the experience that the public interest is best served by having an enterprise operate in a monopolistic fashion and (2) belief that the service rendered is highly essential to the public. In controlling utility enterprises, commissions have usually identified the public interest with earnings on invested capital which are fair and reasonable. In some cases, however, the public interest is defined to include other factors, too. The Civil Aeronautics Board, for example, has the duty to subsidize the industry to the extent necessary for the development of a sound air transportation industry, not only for the purposes of commerce, but also for the national defense. The Interstate Commerce Commission, also, is charged with the duty of "developing, coordinating, and preserving a national transportation system."

In the following sections, we shall consider the activities of the federal commissions as they apply and give force to the main features of control.

THE INTERSTATE COMMERCE COMMISSION

The Interstate Commerce Commission was established in 1887 and is the oldest of the various federal commissions. It now consists of eleven members appointed by the President, with the "advice and consent" of the Senate, for terms of seven years. No more than six of the commissioners may be appointed from the same political party. The jurisdiction of the ICC, in general, extends to all forms of interstate public transportation, except air carriers, pipelines for gas and water, and certain motor and water carriers operating in metropolitan areas.[9] In this capacity, the ICC regulates rates for railroads in the United States, as well as for oil pipelines, sleeping-car service, express service, motor carriers operating in interstate and foreign

[9] Air carriers are regulated by the Civil Aeronautics Board, while gas pipelines are controlled by the Federal Power Commission. There is no federal control over water pipelines.

commerce, water carriers engaged in coastwise and intercoastal commerce and upon inland waters of the United States, and freight-forwarding companies. It also has certain jurisdiction over private car lines.

The act of 1887 was passed as a result of the Cullom Report of 1886, which revealed the widespread existence of railroad abuses.[10] These abuses included numerous examples of discriminatory pricing, resulting in large measure from a desire to maximize profits by "charging what the traffic will bear." Rates were made unreasonably higher at local, noncompetitive points (possibly nine-tenths of all stations) than on longer hauls to destinations and terminal points which were highly competitive. Startling discriminations were also practiced between persons and various classes of goods. Secret rebates were paid to favorite shippers, and monopolistic agreements were made to pool earnings and the volume of traffic.

In the same year that the Cullom Report was issued, the Supreme Court ruled that state regulation of interstate rates was unconstitutional.[11] Since most railroad transportation involved interstate hauls, Congress thereupon took steps to meet its responsibility by enacting the Interstate Commerce Act of 1887.

The Interstate Commerce Act, as amended, among other things requires a publication of rates and prohibits "unjust and unreasonable rates." Discrimination between persons and unjust discriminations between places and goods are declared to be illegal. The act also outlaws higher charges for the transportation of passengers or property over a shorter than a longer distance, over the same line, the shorter being included within the longer distance, except where Commission approval is obtained.

The work of the Interstate Commerce Commission was long handicapped by a series of adverse Supreme Court decisions restricting its powers of control. A decision of 1897, for example, held that the ICC could not fix rates, but only declare existing rates unreasonable.[12] Since a railroad could change its rates slightly upon getting an adverse decision, the ruling meant that a new complaint would have to be brought and again carried through the courts. It was not until 1906, when the act of 1887 was amended to give the Commission power to set maximum rates, that it could begin to exercise effective control over the railroad industry. The Commission's authority to control local discrimination was also nullified by adverse court decisions; and it was not until 1910 that it secured a revitalized power to prohibit, in most cases, the charging of a higher rate for a shorter than for a longer haul over the same route in the same direction. The Transportation Act of 1920 included a rule of rate-making which provided for the control of rates by the Commission so that the carriers as a whole, or by various groups, would earn a "fair return" on the "fair value" of the prop-

[10] *Report of the Select Committee on Interstate Commerce*, 49th Congress, first session, Senate Report 46, Part 1, 1886.

[11] *Wabash, St. L. and P.R.R.* v. *Illinois*, 118 U.S. 557 (1886).

[12] *ICC* v. *Cincinnati, New Orleans, and Texas Pacific Railway Co.*, 167 U.S. 479 (1897).

erty. The act of 1920 also gave the Commission the power to establish minimum rates and even specific rates. This legislation, subsequently, was repealed.

Not long after the Commission secured effective means of control over the railroads, new forms of transportation began to develop—private automobiles, motor carriers, improved ships and tankers, and finally air carriers. Pipelines, brought under regulation in 1906, also became increasingly important in this period. These new types of competition served to change the problems with which the ICC had to deal. The business depression which began in 1929 also brought new problems and served to accentuate the difficulties involved in rate-making. In the face of a general decline in prices, the Commission found that the fair-return-on-the-fair-value rule was no longer satisfactory as a pricing formula. Railroad managements and many investors, however, believed that they were entitled to earn a fair return on the past investment regardless of economic conditions or technological improvements.

NATIONAL TRANSPORTATION POLICY

Changed conditions for the railroad transportation industry led Congress in 1940 to declare a new regulatory policy. According to the Transportation Act of 1940—an amendment to the Interstate Commerce Act—a "national transportation policy" is established as follows:

> It is hereby declared to be the national transportation policy of the Congress to provide for fair and impartial regulation of all modes of transportation subject to the provisions of this Act, so administered as to recognize and preserve the inherent advantages of each; to promote safe, adequate, economical, and efficient service and foster sound economic conditions in transportation and among the several carriers; *to encourage the establishment and maintenance of reasonable charges* for transportation services, *without unjust discriminations*, undue preferences or advantages, or unfair or destructive competitive practices; to coöperate with the several states and the duly authorized officials thereof; and to encourage fair wages and equitable working conditions; *all to the end of developing, coördinating, and preserving a national transportation system by water, highway, and rail, as well as other means, adequate to meet the needs of commerce of the United States, of the Postal Service, and of the national defense.*[13]

In applying the standard of reasonableness to rates and charges, the Commission is charged with the duty of carrying out the national transportation policy. This policy, in essence, is one of "developing, coördinating, and preserving a national transportation system," and commission control is to be directed to that end. At the same time, however, under the terms of

[13] *United States Statutes at Large*, 76th Congress, third session, Vol. 54 (Washington, 1940), Part 1, p. 899. Italics supplied.

the act, the Commission is not permitted to disregard the interests of the shippers.

In approving rates, the Commission is directed to give due consideration (1) "to the effect of rates on the movement of traffic by the carrier or carriers for which the rates are prescribed," (2) "to the need, in the public interest, of adequate and efficient railway transportation service at the lowest cost consistent with the furnishing of such service," and (3) "to the need of revenues sufficient to enable the carriers, under honest, economical, and efficient management to provide such service." Maximum, as well as minimum, rates may be prescribed.

Customarily, the rates charged by common carriers are fixed by the carriers themselves and simply filed with the ICC. As we have seen, the various carriers—rail, water, truck, and air—have secured exemptions from the anti-trust laws with respect to their rate-making activities. In accordance with these privileges of legalized monopoly action, it is usual for the various companies in a given line of transportation—and sometimes in related lines—to meet together in rate-making conferences to fix rates by concerted action. These rates are thereupon submitted to the ICC. The Commission is empowered to investigate any and all rates proposed, either upon complaint or upon its own motion. It is also authorized to set aside proposed rates and to prescribe rates which it believes are in accordance with the act of 1940 and the orders of the Commission.

Transportation Act of 1958

In 1958 Congress again amended the Interstate Commerce Act of 1887. This legislation authorized the Commission to approve federal guaranty of certain loans to railroads, provided additional means by which railroads could discontinue unprofitable train service, and reduced the number of agricultural commodities formerly exempt from economic regulation by the ICC when transported by motor carrier.

The Transportation Act of 1958 also amended the Interstate Commerce Act to provide that in a proceeding involving competition between carriers of different modes of transportation subject to this Act, the Commission, in determining whether a rate is lower than a reasonable minimum rate, shall consider the facts and circumstances attending the movement of the traffic by the carrier or carriers to which the rate is applicable. Rates of a carrier shall not be held up to a particular level to protect the traffic of any other mode of transportation, giving due consideration to the objectives of the national transportation policy declared in this Act.

Railroad Rates in a Defense Economy

Since World War II, the Interstate Commerce Commission has authorized a number of railroad rate increases in line with increased labor, material, and

tax costs. The most important decision with respect to the various rate increases was that of *Ex Parte 175, Increased Freight Rates, 1951*, decided April 11, 1952 (284 ICC 589). In this decision, the Commission authorized a general increase of 15 percent in the basic rates and charges of railroads, water carriers, and freight forwarders, to continue until February 28, 1954. The decision of 1952 is important because in it the Commission ruled that the railroads, during a period of defense mobilization, should be permitted to charge rates which will provide revenue not only for operating costs, depreciation, and a reasonable rate of return, but also for some increase in capital investment. Said the Commission in support of its decision:

> We believe at a time when the Nation is bearing arms against aggression and undertaking extraordinary efforts in the way of defense mobilization for peace, the developing of a transportation system by rail adequate to meet the needs of national defense, within the meaning of the national transportation policy, requires attention on our part in a proceeding of this kind, and warrants a degree of liberality in decision not otherwise to be taken into account. . . . We are not convinced that *money necessary for capital additions* to the railway systems should be derived wholly from income, but we must take note of the fact that many of these outlays are being made under the encouragement, if not the insistence, of the Government and the shipping public, with national defense primarily in mind. Such circumstances, therefore, bear upon our decision in this case.[14]

On July 29, 1953, the Commission extended the expiration date of the 1952 order, and on October 17, 1955, the order granting the increase was made permanent. In extending the rate order of 1952, the Commission emphasized again that liberality in earnings would facilitate the maintenance of the carriers for meeting the needs of defense. "Our experience in the past," it was stated, "indicates that our transportation system may, without extensive notice, be called upon to make extraordinary exertions in behalf of national defense. There should be some insurance against any possible slowdown or breakdown in transportation service, and that fact may well resolve same doubts about the propriety of increases in rates which might otherwise prove insuperable."[15] Since 1955, continuing increases in wages and other costs have led to additional increases in freight rates.

In 1957, an increase of 12 percent in railroad class rates was authorized throughout the country. With reference to this increase, the eastern and western railroads argued that the minimum level of earnings needed to produce a sound condition in the railroad industry may be measured by an average return of at least 6 percent. Recognizing the inherent difficulties involved in estimating a "fair" annual rate of return on the "fair" capital value of railroad facilities, the Commission "concluded that there is no statu-

[14] *Ex Parte 175, Increased Freight Rates, 1951*, 281 ICC 557, 637 (1951). Italics supplied. See also 284 ICC 589, 660 (1952).

[15] Interstate Commerce Commission, *Ex Parte 175, Increased Freight Rates, 1951*, Report of August 10, 1953, mimeographed, p. 73.

tory requirement or statement of policy that calls for the fixing of rates so as to yield a certain rate of return on investment, either in the United States as a whole or in various rate territories."[16]

The Commission in its 1957 rate increase authorization also stated "the record makes amply clear that the carriers are faced with other increased costs by the end of 1957, which are not definite and certain. . . . When these become an actuality, the respondents may further petition us in this proceeding to modify our outstanding orders so that they may file schedules, accompanied by adequate justification, subject to protest and possible suspension, proposing further moderate increases in such rates and charges to cover additional increases in expenses which have materialized."

So it is that today rate control by the ICC largely takes the form of a public scrutiny of costs and earnings, with a granting of rate increases on the basis of increases in wages and other carrier costs of operation, to produce a sound condition in the railroad industry.

THE CIVIL AERONAUTICS BOARD

The Civil Aeronautics Act of 1938, as amended, provides for the establishment of the Civil Aeronautics Authority, a five-man administrative agency similar to the ICC, appointed by the President, with the advice and consent of the Senate, to prescribe economic regulations and safety rules for the air transportation industry. The Civil Aeronautics Authority was subsequently redesignated as the Civil Aeronautics Board. This designation was continued in the Federal Aviation Act of 1958 which reiterated the Board's jurisdiction over interstate rates for (1) the transportation of mail by aircraft and (2) the transportation of persons and property. In practice, the Board also exercises a broad power over intrastate air commerce. This is in accordance with the decisions of the Supreme Court permitting Congress to regulate *intrastate* transportation in order to make effective its control over *interstate* transportation. Although the rates which are established are required to be fair and reasonable, the Board is directed to approve rates which will provide for the *development* of air transportation and the *needs* of commerce, the postal service, and national defense.

In addition to its control over rates, the Civil Aeronautics Board is given authority over other aspects of the inner workings of air transportation companies. It is empowered to require annual, periodic, and special reports from any air carrier on any subject deemed necessary, including contracts, agreements, understandings, or other arrangements which a carrier may have with any other carrier or person with respect to air traffic. Air carriers are required to submit annually a list of stockholders owning more than 5 percent of their capital stock, and officers and directors are required to

[16] Interstate Commerce Commission, *72nd Annual Report* (Washington, D.C., 1958) p. 31.

submit a report on any stock or interest which they hold in any phase of aeronautics. The Board is authorized to prescribe the form in which accounts are to be kept and to inspect all accounts, letters, records, and facilities. All rates, fares, and charges for air transportation must be filed with the Board and posted publicly. Rebating is prohibited. Unfair methods of competition, unjust discrimination, and unfair and deceptive practices are also prohibited, and the Board is given authority to issue cease-and-desist orders (see also Table 2, pages 46–47).

For purposes of regulation, airlines companies are grouped into two categories: (1) certificated carriers and (2) noncertificated carriers. Certificated carriers are those which have been certified as being essential for the public convenience and necessity. Most of these companies are authorized to carry airmail and all other forms of revenue traffic between certain designated points. Certain smaller companies are certificated to operate between unspecified points but with a limit on the number of such operations which they may perform. A noncertificated carrier, on the other hand, operates without a certificate of convenience and necessity from the Civil Aeronautics Board and is exempted from many of the regulations of the board.

Measures to Restrict Concentration of Control

The Act of 1958 continues the prohibition enacted in 1938 against consolidations, mergers, or contracts designed to give an air carrier a control over any other company or property in the field of aeronautics, unless such arrangements are approved by order of the Board. Interlocking directorships, likewise, are prohibited, unless they are given specific approval. In each instance, the Board is given authority to approve consolidations, mergers, or interlocking relationships if it finds that the public interest is not adversely affected. The act, however, expressly provides that the Board shall not approve a merger or acquisition which will result in creating a monopoly or monopolies. All agreements made between and among carriers with respect to rates, fares, classifications, the pooling of earnings, or other matters are required to be submitted to the Board for approval or disapproval. Finally, it is provided that if the Board issues an approval order with respect to mergers, acquisitions, interlocking relationships, or agreements on rates and other matters, the company or companies concerned will be exempted from the operation of the Clayton Act and the other antitrust laws.

At the time that the Board was established, a high degree of economic concentration and oligopoly had already come to exist in the air transport industry. In an effort to modify this condition, the Board stated in a decision rendered in 1940 that its policy would be one of developing and preserving a system of "balanced competition"—that is, a condition of numerous companies fairly evenly balanced in size. To this end, it declared that it would endeavor to strengthen the smaller carriers by granting them new routes and

service extensions. The basic principle involved was stated to be that of seeking to provide a degree of competitive stimulus and to avoid granting a single company the exclusive right to exploit a specific sales area. In the words of the Board,

> It is the concentration of ownership and control which is fatal to the operation of a competitive economy. To allow one air carrier to obtain control of air transportation in the west coast area greatly in excess of that possessed by competitors would, in our opinion, seriously endanger the development of a properly balanced air-transportation system in this region; and the elimination of the only independent north and south air carrier west of the Rocky Mountains might be expected to retard the promotion of air travel in this direction.[17]

The policy of "balanced" or "constructive" competition, it may be noted, does not mean that the board seeks to maintain price competition in the antitrust law sense. The Board, in fact, has declared that it will not employ the economic definition of monopoly as "restraint of competition" in its regulatory activity. It proposes rather to identify monopoly with that degree of ownership which it believes gives rise to a control of air transportation in the whole or any significant part of the United States.[18] In the eyes of the Board, the "competition" which is to be maintained as far as possible is essentially a *service* or *sales* competition.

Rates and Subsidies

In exercising its rate-making powers and duties, the Board is directed to consider, among other factors:

> The need of each such air carrier for compensation for the transportation of mail sufficient to insure the performance of such service, and, together with all other revenue of the air carrier, to enable such air carrier under honest, economical, and efficient management, to maintain and continue the development of air transportation to the extent and of the character and quality required for the commerce of the United States, the postal service, and the national defense.[19]

The Act states further that the Board may prescribe upon complaint, or upon its own initiative, the lawful rate, or the maximum and minimum rates, for the carriage of persons and property by air, whenever it finds that existing rates are unjust, discriminatory, or unduly preferential.

Upon the bases of the need or so-called "subsidy" provision, quoted in the preceding paragraph, the Board uses airmail payments to provide total revenues which will permit a carrier to earn a fair return on operations

[17] *United Air Lines Transport Corporation—Acquisition of Western Air Express Corporation*, 1 CAA 739, 750–751 (1940).

[18] *United AL—Western AE, Interchange Equipment*, 1 CAA 723, 733 (1940).

[19] Civil Aeronautics Act, Sec. 406-b.

TABLE 28. Administrative Separation of Subsidy from Total Mail Payments for United States Certificated Air Carriers

	Fiscal Years					
	1955	1956	1957	1958	1959[a]	1960[a]
Service mail pay (000)						
Domestic trunks	$29,655	$30,880	$32,959	$34,788	$37,360	$39,983
Local service	1,373	1,149	1,246	1,257	1,346	1,442
Helicopters	277	235	240	226	237	240
All-cargo	—	184	497	328	246	263
International, overseas, and territorial	25,147	28,598	30,121	31,651	33,751	35,878
Total	$56,452	$61,046	$65,063	$68,250	$72,940	$77,806
Subsidy payments (000)						
Domestic trunks	$ 3,054	$ 1,857	$ 2,260	$ 2,853	$ 1,228	$ —
Local service	22,571	24,636	28,646	33,340	36,704	44,458
Helicopters	2,656	2,726	3,574	4,188	4,864	4,873
All-cargo	—	—	—	—	—	—
International, overseas, and territorial	16,433	14,549	10,099	7,930	8,535	7,955
Total	$44,714	$43,768	$44,579	$48,311	$51,331	$57,286

[a] Estimated.
SOURCE: Civil Aeronautics Board.

required in the national interest. The principle followed in fixing mail pay has been to make up, under conditions of careful control, the difference between the operating revenue of a carrier and its operating expense and to provide a fair return on invested capital. The essential idea has been that a carrier should be allowed to "break even" and to have something left over to induce it to provide safe and adequate service.[20]

The airmail payments established by the Board in *some* cases, thus include not only compensation for carrying the mail, but also a subsidy to accomplish the board purposes of the Federal Aviation Act (see also Table 28). At the present time, the Post Office Department makes the service mail payments to the air carriers, and the CAB pays the outright subsidies.

THE JURISDICTION OF THE SECRETARY OF THE ARMY OVER THE CHARGES OF TOLL BRIDGES

The Secretary of the Army has been given jurisdiction by Congress, with certain exceptions, over the tolls charged for passage over bridges which span any of the navigable waters of the United States. The tolls charged by the owners are required to be just and reasonable, but formal approval of proposed rates is not considered to be necessary. The Department of the Army may act in response to a complaint that tolls are unreasonable on its own initiative, or at the request of the bridge owners. Where a controversy

[20] See, for example, Civil Aeronautics Board, *Braniff Airways, Inc.*, Docket 2680 (adopted September 2, 1948), pp. 29–30.

exists, the Secretary of the Army may determine the reasonableness of tolls only after full investigation and after giving all interested parties a reasonable opportunity to be heard.

It is the policy of the Department to act in complaint cases only upon receipt of specific information from which it can be reasonably inferred that existing rates are excessive. Complaints from municipal authorities, civic bodies, other organizations, or a substantial number of users of the bridge which make a strong preliminary showing that existing rates are unreasonable are preferred. Upon receipt of such a complaint the District Engineer, Corps of Engineers, is first directed to make a preliminary investigation with a view to determining whether a full investigation is justified. On the basis of his report the Department then determines whether a full investigation including public hearings should be made. Not until the completion of such an investigation is the Department in a position to decide that the existing tolls are proper or to prescribe such other rates as may be found reasonable.

According to the records of the Office, Chief of Engineers, rates of tolls have been prescribed by the Secretary of the Army for forty-two existing bridges, and investigations have been made by the Department in numerous other cases where no change in existing rates was found to be justified. After an order of the Secretary of the Army takes effect, it is unlawful to collect a toll in excess of that so prescribed.

FEDERAL COMMUNICATIONS COMMISSION

The Federal Communications Commission is the federal agency charged with regulating interstate and foreign communication by means of radio, wire, and cable.

The Communications Act of 1934, as amended, provides for the creation of the Federal Communications Commission, an independent regulatory agency, composed of seven commissioners appointed by the President, subject to confirmation by the Senate. The Commission has powers of regulation over (1) all interstate and foreign common carrier operations of domestic companies by wire and radio (telegraph, telephone, and submarine cable); (2) nonbroadcast radio facilities (safety and special); and (3) broadcast (program) stations, radio and television. The purposes of this regulation are to provide for orderly development and operation of broadcasting services; to insure efficient, nation-wide and world-wide telegraph and telephone service at reasonable charges; to promote the safety of life and property by improved communications systems; and, generally, by such means, to strengthen the national defense.

The Communications Act was adopted by Congress in 1934 after a Congressional committee had reported that "at the present time there is little, if any, federal regulation of the rates, practices, and charges of the several branches of the communications industry. . . . The American people are

entitled to know if they are being overcharged for this service, though they may be satisfied with the quality of the service." With special reference to the telephone industry, the report declared that the "telephone business is a monopoly—it is supposed to be regulated. Thus far regulation, particularly by the federal government, has been nominal . . ."[21]

FCC Regulation of Radio Stations and Radio Operators

The Communications Act requires all nongovernment radio transmitters and radio operators to be licensed. At the present time, the number of radio authorizations exceeds 2.3 million, covering one-half a million stations and 1.8 million radio operator permits of different grades (see Table 29). Each year the Commission receives some 540,000 radio applications for station and operator permits.

TABLE 29. Radio Authorizations Granted by the Federal Communications Commission

	June 30, 1935	March 31, 1959
Stations		
Marine	2,157	80,876
Aviation	678	74,455
Public safety	298	28,733
Industrial	146	46,565
Land transportation	0	55,412
Amateur	45,561	192,364
Broadcast	623	9,839
Common carrier	565	3,659
Experimental	1,012	886
Other	34	9,262
Subtotal	51,074	502,051
Operators		
Commercial	21,000	1,654,192
Amateur	36,525	185,000
Subtotal	57,525	1,839,192
Grand total	108,599	2,341,243

SOURCE: Federal Communications Commission.

FCC Broadcast Regulation

A major activity of the FCC is the regulation of broadcasting—visual as well as aural. In this work the Commission (1) allocates spectrum space to the various types of broadcast services and (2) grants licenses to operate individual broadcast stations. Licenses are granted only to citizens of the United States, and the present broadcast license period is three years. There

[21] *Preliminary Report on Communication Companies,* 73rd Congress, second session, House Report 1273, 1934, Vol. 5, Part 1, pp. xvi–xxxi.

is no fee or charge of any kind for a license. The number of licensed broadcast stations is shown in Table 30.

TABLE 30. Broadcast Stations Licensed Since 1949

Year	Commercial AM	Commercial FM	Educational FM	Commercial TV	Educational TV
1949	1,963	377	31	13	—
1950	2,118	493	61	47	—
1951	2,248	534	82	81	—
1952	2,333	582	91	96	—
1953	2,439	551	106	101	—
1954	2,565	529	117	104	—
1955	2,719	525	121	137	1
1956	2,871	519	126	186	1
1957	3,044	519	135	344	14
1958	3,218	526	144	427	29
1959	3,328	578	150	475	37

SOURCE: Federal Communications Commission.

Under the Communications Act, each broadcast station licensee is privileged to arrange its own program structure independently. The FCC has no authority to require a broadcast station to carry or not to carry a particular program, or to say how it should be presented. The operations of a station, however, are required to be in the public interest. When an application for the renewal of a license is made, the Commission reviews the operations of the station to see what the performance record has been.

The Communications Act declares that broadcasting is not a common carrier (public utility), so that a broadcast station is not required to sell or give time to all who seek to go on the air. However, the Act does expressly provide that if a licensee shall permit a legally qualified political candidate to use its facilities, it shall afford equal opportunities to all other such candidates. The FCC has no authority to regulate the time charges of broadcast stations, profits, artists' salaries, or employee relations.

The FCC has adopted rules under its regulatory powers prohibiting the same interest or group from operating more than one network, or more than one AM, FM, or TV station in the same area, or more than seven AM, seven FM, or seven TV commercial stations throughout the country as a whole

The Communications Act provides that "all laws of the United States relating to unlawful restraints and monopolies and to combinations, contracts, or agreements in restraint of trade are declared to be applicable . . . to interstate or foreign radio communications." Moreover, the act provides that if a broadcasting company is convicted of violating the antitrust laws, the court may order a revocation of its license.

The FCC does not license sets which are for reception only, and it does not regulate their production or sale. It does, however, impose limitations on radiations which may interfere with radio or TV service.

Since the number of radio and TV stations which can be permitted to operate in the United States is limited by the available frequency range, it follows that in many localities the privilege of having a license is of great value. In practice, the established radio companies confidently expect their licenses to be renewed indefinitely. The result is that present station owners are proceeding to operate on the presumption that they have a vested interest in a particular frequency channel on the radio spectrum. In certain instances, stations have been sold at prices far above the value of the physical facilities. At various times the Commission has asked Congress what policy it should follow in passing upon the transfer of stations where the sales prices are far in excess of the physical property values, but Congress has not replied.

FCC Regulation of Common Carriers

Interstate and foreign communication by radio, wire, and cable is declared by the Communications Act to be a public utility (common carrier), and the FCC has authority to supervise charges and practices. The rates of common carriers of messages—telegraph and telephone—are required to be "just and reasonable"; and the Commission is empowered to determine maximum and minimum rates, as well as the actual rates which may be charged. All rates must be filed with the Commission and posted for public inspection. Undue or unreasonable discrimination is prohibited. The Commission is authorized to prescribe uniform systems of accounts for use by telegraph and telephone carriers in interstate and foreign commerce. It also is required by law to approve the construction of new lines and the extension of interstate service; to regulate the interlocking of officers and directors; and to pass upon applications of communications companies for authority to merge or consolidate. A significant shortcoming of the act of 1934 is that no control was given to the Commission over the terms of purchase contracts made by an operating company with an affiliated company. Also the Commission was given no control over the issuance of securities.

Although the act of 1934 provides for the making of property valuations of companies subject to regulation, the Commission has not sought to set rates upon the basis of valuation standards.

As a result of Congressional investigation of the telephone industry in 1939, the Commission has been able to secure several reductions in long-distance telephone rates by means of negotiation and agreement. Most recently, in July 1959, the FCC announced that by negotiation and discussion the American Telephone and Telegraph Company agreed to file revised rates reducing by about $50,000,000 annually its charges for interstate long-distance telephone calls.

The American Telephone and Telegraph Company, it may be noted, has an almost complete national monopoly of the telephone business. According to the Federal Trade Commission, "the Bell System," controlled by the

American Telephone and Telegraph Company, is the "largest aggregation of capital and resources that has ever been controlled by a single private company at any time in the history of business. The system consists of over 200 corporations directly and indirectly controlled by the American Telephone Company. This company controls between 80 and 90 percent of local telephone service and 98 percent of the long distance telephone wires of the United States, including practically all wire facilities used in radio program transmission."[22]

Intrastate telephone service is subject to state control by the several state commissions. Since substantially all telephone facilities are used in common in interstate and intrastate service, public regulation requires the separation of property and expense. The Supreme Court has ruled that separations should be based upon the relative use of property in the two different services.[23] The same principle, it may be noted, applies to the control of telegraph, railroad, motor carrier, air carrier, and gas and electric utilities. Not all states, however, control the various intrastate operations of interstate utilities.

CONTROL OF STOCKYARD CHARGES BY THE SECRETARY OF AGRICULTURE

The large combinations in the meat-packing industry, Armour, Swift, Wilson, and Cudahy, have long been under government scrutiny for possible collusive action with respect to prices and market sharing. In 1905, as we have seen, the federal government secured an injunction against various monopolistic practices carried on by the large packers in the meat industry.[24] Again, in 1919, the Federal Trade Commission reported that the large packers were not only continuing the collusive practices found in 1905 but were also controlling the stockyards in the principal market centers.

The investigations of the Federal Trade Commission led Congress to enact the Packers and Stockyards Act of 1921. Industry members claimed that the Federal Trade Commission had become prejudiced against it, and the legislation provides for its enforcement by the Secretary of Agriculture.

The main purposes of the act of 1921 are (1) to provide patrons of the public stockyards with open competitive markets for livestock, free from collusion and unfair-trade practices by those in livestock marketing or by the meat-packing industries; (2) to require operators of public stockyards to furnish stockyard services at fair and nondiscriminatory rates to all patrons; and (3) to make it unlawful for meat packers or handlers (a) to

[22] Federal Trade Commission, *Investigation of the Telephone Industry in the United States*, 76th Congress, first session, House Document 340, 1939, p. XXIII.

[23] See *Minnesota Rate Cases*, 230 U.S. 352 (1913).

[24] *Swift and Co.* v. *U.S.*, 196 U.S. 375 (1905).

engage in unfair or deceptive practices, (b) to make or give undue preferences, and (c) to manipulate or control prices or restrain commerce.

In 1935 the act of 1921 was amended to bring the handling of live poultry in large cities under the provisions of the law relating to services, facilities, rates, and charges, whenever the Secretary of Agriculture finds that "unfair, deceptive, and fraudulent practices" warrant such action.

A further amendment, passed in 1958, specifically provides that jurisdiction of the Secretary of Agriculture in the act of 1921 shall apply with respect to "livestock, meats, meat food products, livestock products *in unmanufactured form*, poultry, or poultry products" (italics supplied). Section 3 of the amendment of 1958 at the same time makes it clear that the Federal Trade Commission shall have jurisdiction over persons, partnerships, and corporations engaged in the handling and sale of meat products, meat food products, and livestock products, not subject to the Secretary of Agriculture.

At the present time, 66 terminal markets and 263 livestock auction markets are supervised by the Secretary of Agriculture. Some 2300 commission firms and 2700 dealers are registered for buying and selling in these markets. More than 1900 packers are also subject to the provisions of the Act. The marketing of live poultry is supervised in seven major cities, and some 1500 licensees (commission merchants and dealers in poultry) are operating under the supervision of the Secretary of Agriculture.

The act of 1921 (1) forbids various commercial practices—such as apportioning supplies and manipulating or controlling prices—and (2) provides that the rates of public stockyards and market agencies "shall be just, reasonable, and non-discriminatory." The Secretary of Agriculture is given authority to supervise the business practices of packers, dealers, and market agencies; to prosecute alleged violations; and to obtain compliance with the law. A field supervisory force is maintained at twenty of the principal central markets. These marketing specialists observe the daily operations in the yards and market houses. Technical violations of a minor nature are disposed of by informal discussion. Violations which do not involve intentional dishonesty or an element of fraud are frequently settled by the signing of a stipulation—an agreement to discontinue the unlawful practice. More serious types of violations are handled by the issuance of formal complaints. Hearings are conducted, and cease-and-desist orders are issued if violations are found to exist. These orders may be appealed to the courts; but when they are approved or accepted, they serve as an injunction against the unlawful practices. In the case of violations by commission men and dealers, the order may provide for the suspension of an individual's registration or license.

During the period of 1921 to 1960, the Secretary of Agriculture has filed charges in more than 2200 cases for violations of the act of 1921. About 200 of these cases were directed against monopolistic practices and monopolistic conditions.

To insure that the rates and charges of stockyard owners and market

agencies (livestock commission men) are just, reasonable, and nondiscriminatory, the act of 1921 provides that the Secretary of Agriculture may upon his own motion or upon complaint investigate the existing rates or charges and after a "full hearing" prescribe the specific rates which a stockyard or a market agency must charge. The act does not provide any formula for rate-making, and the Secretary has not adopted any single standard.[25]

The task of setting a fair and just charge for the services of livestock commission agencies presents a problem which is different from that of other public utilities, for the amount of capital investment required in the business is negligible. Commission rates for selling livestock shipped in from the country have typically been set by the collective action of the commission men themselves, and government intervention is necessary to protect shippers from excessive charges. In setting the selling rates the Secretary of Agriculture endeavors to estimate the competitive salary which is paid for competent employee salesmen for a reasonable year's work, as well as a reasonable sum for travel, entertainment, advertising, office overhead, interest, and related expenses. Upon the basis of these data, the Secretary prescribes the rates to be charged for the sale of cattle, sheep, and hogs shipped in from the country districts.

THE FEDERAL POWER COMMISSION

The Federal Power Commission was created in 1920 and is presently composed of five members appointed by the President. Its duties consist of administering the Federal Water Power Act of 1920, renamed the Federal Power Act and enlarged by amendment in 1935, and the Natural Gas Act of 1938. The purposes of these statutes are (1) to control the nation's water-power resources subject to federal jurisdiction for the benefit of all the people and (2) to regulate *interstate* electric and natural gas utilities, so that their rates, services, and financing will be in the public interest.[26]

The Federal Water Power Act of 1920 empowers the Commission to collect information on the water-power resources under the jurisdiction of the federal government and to grant licenses for their use and development. Under its power to regulate interstate commerce, Congress has jurisdiction over power sites on navigable waters and public lands of the United States. All such power sites may now be licensed for private use, but not sold. The law provides that licenses "shall be issued for a period not exceeding fifty

[25] For an analysis of the rate-making policies used by the Department of Agriculture, see *In re St. Louis National Stockyards Company* (1946), P. and S. Docket 1246, in *Agricultural Decisions*, Vol. 5, p. 338; and *In re Market Agencies at the Sioux City Stockyards* (1950), P. and S. Docket 308, in *Agricultural Decisions*, Vol. 9, p. 4.

[26] In addition, the Commission has duties under certain sections of the Tennessee Valley Authority Act, the Bonneville Act, the Fort Peck Act, the Eklutna Project Act, and the various Flood Control and River and Harbor Acts, beginning with the Flood Control Act of 1938.

years." Most of the licenses issued by the Commission have been for that period.

The act of 1920 gives the Commission authority to control rates for power from licensed projects under stated conditions. In 1935, these powers were extended to cover power transmitted in *interstate* commerce. The Commission may also provide for the control of *intrastate* rates involving power from a licensed project, if the state concerned does not have a utility commission. Companies granted licenses are required to agree to the use of original cost, less certain prescribed items, as the basis for rate-making; and the Commission is given authority to demand cost records and to determine rates of depreciation.

Federal control of water-power resources seeks to limit the profits of interstate electric utilities *to a fair return on their net original investment*, and to prevent an inclusion in the rate base of a capitalized value on power sites which belong to the people. As early as 1909 President Theodore Roosevelt pointed out the need for federal control of power sites on streams subject to the jurisdiction of Congress. "To give away, without conditions, this, one of our greatest resources," he declared, "would be an act of folly. If we are guilty of it, our children will be forced to pay an annual return upon a capitalization based upon the highest prices which 'the traffic will bear.' They will find themselves face to face with powerful interests intrenched behind the doctrine of 'vested rights' and strengthened by every defense which money can buy and the ingenuity of able corporation lawyers can devise."[27]

In the discussions in Congress on proposals which led to the act of 1920 there was general agreement that "water-power opportunities are in a certain sense the property of all the people and should not be permitted to pass in perpetuity into private ownership." By adopting a policy of licensing the power sites, it was believed, the public could take over the resources at a later date, if it so desired without payment for "water-power rights" and other intangibles which in reality belong to the people. Water power is a perpetual resource, and the general view of Congress was that it should be reserved in perpetuity for the people.[28]

In 1935 the title of the act of 1920 was changed to the Federal Power Act (by Title II of the Public Utility Act of 1935), and the scope of the statute was enlarged to give the Federal Power Commission authority to fix the rates and charges for all electric energy sold at wholesale in *interstate* commerce, whether or not the utilities concerned are licensed by the Commission. This legislation was made necessary by several decisions of the Supreme Court holding that interstate wholesale rates could not be controlled by the

[27] *Special Message of the President of the United States*, 60th Congress, second session, House Document 1350, 1909, pp. 5–6.

[28] *Development of Water Power*, 63rd Congress, second session, House Report 842, 1914, p. 10; and *Development of Water Power*, 64th Congress, first session, Senate Report 66, 1916, pp. 8–9.

states. The investigations of the Federal Trade Commission also had revealed the existence of flagrant abuses in the management of many electric utilities, particularly the holding companies, which the state agencies were unable to correct.[29] Every utility subject to the act is now required to file with the Commission, when requested, "an inventory of all or any part of its property and a statement of the original cost thereof," and to "keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction." The Commission is also given authority to prescribe the accounting procedures which a utility must use and to determine and fix adequate rates of depreciation. Inasmuch as the act of 1935 provides for the reporting of original cost data, the Commission controls the rates of utilities subject to this act, as well as those subject to the act of 1920, upon the basis of original cost.

In addition to its control over the transmission and sale of electricity at wholesale in interstate commerce, the Commission has authority over mergers, the sale of properties, the issuance of securities, and interlocking directorates in the case of all electric utility *operating* companies engaged in interstate commerce. In each instance, no action can be taken without authorization by the Commission. The control of these matters in the case of electric utility *holding* companies, it will be remembered, is within the jurisdiction of the Securities and Exchange Commission. Dissolution of most of the holding company systems has removed a large number of operating companies from supervision by the latter agency and placed them under the control of the Federal Power Commission. The Federal Power Commission is also directed to plan for the formation of regional power districts in which production and transmission facilities for electrical power can be coordinated and interconnected.

Control of Natural Gas Rates

The Natural Gas Act of 1938 authorizes the Federal Power Commission to control the rates of companies engaged in transporting natural gas in interstate commerce. The authority of the Commission is limited to the *transportation* and *sale* of natural gas in interstate commerce. The interstate shipment of natural gas is a highly important business, and for many years various state commissions tried to regulate the large interstate companies to prevent unreasonable and discriminatory rates and excessive profits. In 1924, however, the Supreme Court held that a state could not regulate the business of transporting gas by pipeline from one state to another for sale to

[29] Some of the abuses reported by the Federal Trade Commission were (1) loading the capital accounts with arbitrary or imaginary amounts in order to establish a base for excessive rates, (2) writing up the valuations of the fixed assets without regard to their cost and the excessive issuance of securities, and (3) deceptive and unsound methods of accounting for assets, costs, and earnings. For a detailed discussion of these abuses, see James C. Bonbright and Gardiner C. Means, *The Holding Company* (New York, 1932), pp. 143–187.

local distribution companies.[30] Thereupon, it took sponsors of regulation some fourteen years to secure the adoption of control by the federal government.

The basic purpose of the act of 1938 is "to protect consumers against exploitation at the hands of natural gas companies."[31] The law gives the Federal Power Commission the authority, either upon its own motion or upon complaint, to determine just and reasonable rates for the transportation and sale of natural gas piped in interstate commerce. In setting such rates, the Commission is empowered to "investigate and ascertain the actual legitimate cost of the property of every natural gas company, the depreciation therein, and . . . other facts which bear on . . . the fair value of such property." A natural gas company, upon request, is required to furnish the Commission with an inventory of its property and a statement of its original cost. It is also required to provide information on the cost of all additions, betterments, and new extensions, and to use accounting procedures prescribed by the Commission. As in the case of electrical utilities, the procedure of the Commission is to provide for the determination of just and reasonable rates upon the basis of original cost. The Natural Gas Act does not provide for the regulation of security issues. It does, however, require every company seeking to construct and operate interstate facilities, or making a sale of products for resale in interstate commerce, to secure a certificate of public convenience and necessity.

Soon after the Natural Gas Act was passed, the cities of Cleveland and Akron brought complaints against the Natural Gas Pipeline Company of America and the Hope Natural Gas Company with respect to the rates being charged. The decision of the Supreme Court in the Hope Natural Gas case (1944), as we have seen, brought about a marked change in the scope of judicial review. In the Hope case, the Commission authorized rates exclusively upon the basis of original cost. The company, however, contended that weight should be given to reproduction cost. In settling the dispute, the Supreme Court announced the new rule that the orders of a commission will not be disturbed because it used one method of valuation rather than another. The significant factor is the "end result"; and if a company is able to operate successfully with the rates established by the Commission, no appeal would be sustained in the courts.

In the case of *Phillips Petroleum* v. *Wisconsin* (1954), the jurisdiction of the Federal Power Commission over natural gas rates was considerably widened. Under the act of 1938, it was clear that sales by an interstate pipeline company were covered.[32] An unresolved question was whether the

[30] *Missouri* v. *Kansas Natural Gas Co.*, 265 U.S. 298 (1924).

[31] 347 U.S. 672 (1954).

[32] Section 1(b) provides that the Act shall apply "to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption . . . and to natural-gas companies engaged in such transportation or sale."

law governed sales of gas *to an interstate pipeline* made by a producer or gatherer. In the Phillips case, the Court declared that it was "satisfied that Congress sought to regulate wholesales of natural gas occurring at both ends of the interstate transmission systems." Rejecting the contention that only pipeline companies are covered, the Court concluded that the Commission has "jurisdiction over the rates of all wholesales of natural gas in interstate commerce, whether by a pipeline company or not, and whether occurring before, during, or after transmission by an interstate pipeline Company."[33]

COMMISSIONS HANDICAPPED BY INADEQUATE FUNDS

During the post-war years of inflation, the regulatory commissions have not secured the additional appropriations which they have needed to perform their work effectively. At the salaries offered, it is difficult to get and keep professional personnel.

Some observers believe that the appropriations made reflect economy attitudes in Congress during a period when large expenditures have had to be made for defense and foreign-assistance programs. Others believe the restrictions and curtailments reflect pressure on Congress by organized producers in a subtle drive to curb the effectiveness of regulation and control. The basic statutes, it is said, cannot be changed, because public opinion will not support such drastic action. Indirectly, however, they can be changed by reducing the personnel engaged in regulation. Such an attack on the law is not visible, but it does have the result of providing "regulation which doesn't regulate." When staffs are reduced in size, certain activities must be curtailed; and an activity which is typically reduced or eliminated is that of making checks on compliance with orders and regulations.

THE DECLINING "INDEPENDENCE" OF REGULATORY AGENCIES

The principal regulatory agencies, ICC, FPC, FCC, SEC, CAB, NLRB, and FTC were established by Congress as independent agencies. This means that they were created as bipartisan commissions responsible to Congress and not to the President. As "arms of Congress," the commissions are required to report to Congress and to give expression to the statutes enacted by Congress. In making the main regulatory commissions subject to Congress and not to the President, Congress desired to provide regulation which

[33] 347 U.S. 672 (1954).

would be impartial, nonpartisan, and as free as possible from political dictation and intimidation.[34] The President serves not only as Chief Executive, but also as head of his political party. Persons in government responsible to the President give expression to his direction and will; and the President, himself, it is believed by many, may be swayed by the influence of large campaign contributions and the pressure of party supporters.

In recent years, the independent agencies have increasingly become subject to the will of the President. A principal factor shaping this trend was the Reorganization Act of 1949. By the terms of this legislation, the President was given authority to coordinate and improve the functioning of the regulatory commissions. In support of the law, it was urged in Congress that the President should be given power to reduce overlapping efforts and duplicating activities in the interest of greater economy and efficiency. Upon the basis of this legislation, the President now names the chairman for each regulatory commission, except in the case of the Interstate Commerce Commission. The chairmen serve at the will and pleasure of the President. By terms of the reorganization plans, important powers formerly exercised by the commissions themselves were transferred to the chairmen of the commissions. Such powers include (1) the appointment and supervision of personnel, (2) the distribution of business among such personnel, and (3) the use and expenditure of funds. Only in the appointment of the heads of major administrative units must a chairman secure the approval of other commission members.

As a result of the changes under the Reorganization Act, in particular, numerous experts on government believe that the functioning of the regulatory commissions is becoming more and more subject to executive direction and control. The members of a commission, other than the chairman, moreover, are finding that they have little influence in shaping policy or in deciding upon the work to be done. Their equality in administering the law, it is felt, is becoming seriously impaired.

To the extent that the regulatory commissions are "arms of the Executive," their policies and decisions become directly subject to political change and to the prevailing political climate. The historical view and judgment of Congress on the problem of regulation has been that economic regulation should be based upon facts, principles, and rational deliberations, and not upon political expediency and outside pressures.

[34] The position of independent commissions as arms of Congress was well described in *Humphrey's Executor* vs. *U.S.*, 295 U.S. 602, 625–626, 628 (1935). Said the Court: The FTC was established as "a body which shall be independent of executive authority, *except in its selection*, and free to exercise its judgment without the leave or hindrance of any other official or any department of government. . . . Such a body cannot in any proper sense be characterized as an arm or an eye of the executive. Its duties are performed without executive leave and, in the contemplation of the statute, must be free from executive control." Italics supplied.

BASIC CHANGES NEEDED TO STRENGTHEN THE REGULATORY COMMISSIONS

After making a special study of the federal regulatory commissions and private pressures to which they have been subject since the Reorganization Act of 1949, a subcommittee of the House Small Business Committee concluded:

> Congress should act to reëstablish the independence of federal regulatory commissions and agencies. It should remove them from the control and influence of the Chief Executive. It should return them to their original role as creatures and arms of the Congress. . . . The establishment of these bodies was for two essential purposes: to insure against influence, whether expressed or implied, which inevitably comes to bear upon any agency which is an organic part of the executive branch of the Government; and to assure continuity over time in the philosophical concepts underlying the agency's conduct. . . . The orderly processes of government, the faith of the people and all segments of business—large and small—in fair and equitable treatment, are rooted in the independence of the regulatory agencies. No price is too high to maintain the inviolability of this independence.[35]

In 1959 a subcommittee of the House Committee on Interstate and Foreign Commerce conducted extensive hearings on the work of the regulatory commissions and the many improper pressures to which they are subject. A number of specific changes for the operation of the commissions were developed and proposed. Above all, the committee concluded:

> One of the most effective steps, we believe, to strengthen the administration of law by commissions is to have as commissioners and key personnel, men of unquestioned ability and character. The entrustment of great discretionary power, in many instances nonreviewable by the courts, to persons having a modicum of qualifications invites trouble. We strongly urge that appointments to commissionerships be removed from politics and from the influences brought to bear by the more important members of the regulated industry. The national public interest requires that the Executive appoint as commissioners men of independence, experience, and attainment in the field of activities they are called upon to administer. The tenure and compensation of commissioners should be such as to attract to and keep in public service capable men and women. Public service should not be used as a stepping stone to more lucrative employment by a regulated industry.[36]

[35] *The Organization and Procedures of the Federal Regulatory Commissions and Agencies and Their Effect on Small Business*, Select Committee on Small Business, 84th Congress, second session, House Report 2967, 1956, pp. 79–80.

[36] *Independent Regulatory Commissions*, Committee on Interstate and Foreign Commerce, 85th Congress, second session, House Report 2711, 1959, p. 61.

"They Act as if They've Been Doped."

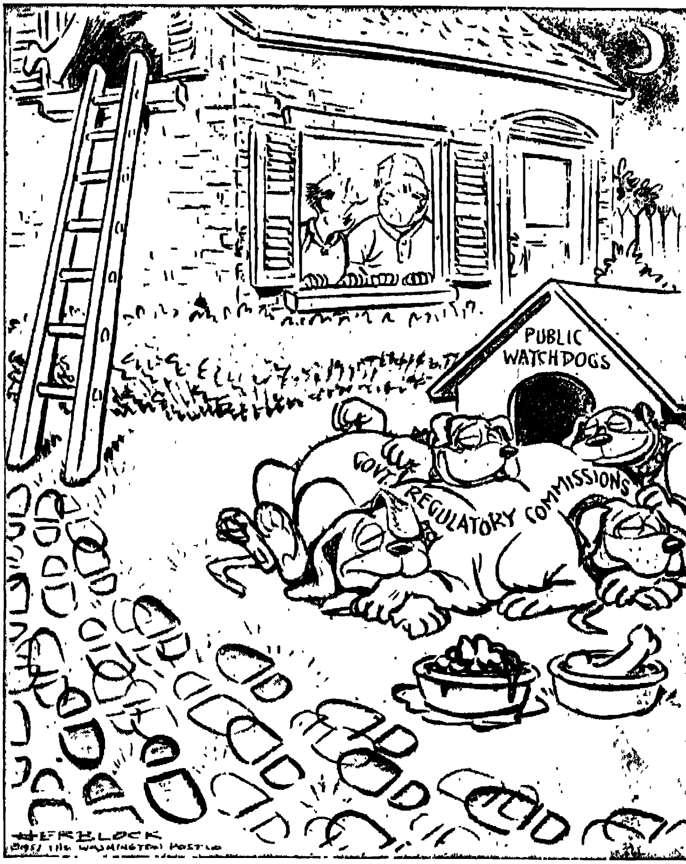

FIGURE 43. A cartoon reflecting opinion on the ineffectiveness of commission control resulting from the failure of the commissions to resist pressures from the White House, from members of Congress, and from private industry. A principal need in commission control is to re-establish the commissions as independent agencies, composed of men who have tenure and a freedom from improper private and political pressures. (From *Herblock's Special for Today* [Simon & Schuster], 1958)

SUMMARY

The essential purposes of public utility control are (1) to prevent a utility enterprise from charging rates which yield a monopoly profit and (2) to prevent rates so low that the service suffers. The basic rule which the Supreme Court has established for rate regulation is that of permitting a utility to earn a "fair return" on the "fair value" of the property which is devoted to

a public use. The judicial rule imposes a *ceiling* for preventing an excessive return and sets a *floor* below which rates may not be reduced by statutory or commission action. In recent years, public utility commissions, in granting rate increases, have given substantial attention to continued increases in wages and other costs of operation. Rate increases have been approved to cover additional increases in expenses. This policy reflects not only the inflationary period which has prevailed since World War II, but also the freedom which commissions have had since the Hope decision (1944) to utilize various procedures in approving rates, so long as the "end result" of their action is reasonable in terms of the functioning of the utility enterprise.

Public utility control does not mean that a utility enterprise will always earn a fair return on the fair value of its property. A utility may actually find it necessary to establish rates which will yield less than the ceiling permitted by law. In some instances, moreover, the rates which a utility decides the "traffic will bear" may not even yield a profit at all, so that the company may face the prospect of bankruptcy or sale to a governmental agency.

22

Government Ownership as an Alternative to Commission Control

There is general agreement that some form of public control must be exercised over the prices charged by a private enterprise having the status of a public utility—that is, in a situation in which an essential service is rendered under conditions of monopoly control. Although certain administrative agencies have done effective work in preventing excessive charges, the record of many commissions on rate control has not been particularly successful from the standpoint of consumers. However, no one having the public interest in mind would propose to abandon such control as we have. Continued efforts must be made to improve the commission process; and if this cannot be done, some authorities suggest that steps should be taken to expand the area of public ownership in this field.

The principal problems in rate control by commissions are (1) the difficulties and complexities which the commissions have had in establishing rate or earnings levels, (2) the delay and time-consuming efforts which are involved in administering direct controls, and (3) the deleterious political influence which is often exerted by the large monopolistic utility organizations.

The purposes of the present chapter are (1) to review the main problems of commission control, (2) to consider the views of various authorities on the experience which the nation has had with commission control, and (3) to analyze proposals for extending public ownership to certain local and national industries which are monopolistic.

PRINCIPAL PROBLEMS OF COMMISSION CONTROL

Technical Difficulties in Rate Control

The policy of the Supreme Court, we have seen, has been to require public service commissions to give appropriate consideration to (1) reproduction cost new less accrued depreciation and (2) original cost less accrued

depreciation in determining the rate base for utility enterprises. Historically, the problem of deciding how much weight to give to one valuation procedure and how much to give to the other has given rise to a considerable amount of variation in calculations of the "fair value" of the property. In this process, the utilities frequently have reached one conclusion, the commissions a different conclusion, and the courts still another.

Even when the procedure of original cost less accrued depreciation is used, difficult administrative problems may arise because a utility may have paid more than the assets acquired were really worth, because its original cost records have been lost, or because its assets are not being fully utilized. It may also be that the original plant investment was a mistake, and the utility may not be able to establish rates which will earn a fair return on the fair value of its property. This situation has frequently arisen in the case of local street railway enterprises.

Delay and Frustration Involved in Direct Control

A second difficulty in the direct control of business enterprises is the inevitable delay involved in the commission process. In investigating rates, it is often necessary for a commission to spend months, and sometimes years, in securing complete inventory records and in making appropriate valuation appraisals. Public hearings must be held to afford the parties due process, and opportunities must be given for filing reply briefs. A dozen or more years may be required in various stages of the investigation, hearing, and judicial review of a single case. The Riss case, for example, was originally filed with the Interstate Commerce Commission in 1935.[1] Some nineteen years later, in 1954, the case was finally terminated! Direct public control by commissions is necessary in certain fields, but it gets into problems of complexity and delay which serve to limit its effectiveness.

The Political Influence Exerted by Private Utilities

Influence on Legislation. A third principal difficulty arising in the commission control of utility companies is found in the pressure and political influence which they exert on (1) the legislative and (2) the administrative branches of government. Great wealth gives rise to undue political influence, and the general public has no counterbalancing organization to offset this pressure. A special study prepared for the Temporary National Economic Committee on the lobbying activities of public utilities reports that "while paying lip service to the principal of public regulation, the railways and

[1] See Interstate Commerce Commission, *Performance of Motor Common Carrier Service by Riss and Co.*, Case No. MC-C-482, decided June 10, 1948. After the decision of June 10, 1948, the company appealed various portions of the order. Finally, in February, 1954, the case was settled.

electrical utilities have done everything in their power to avoid it, or at least to control it in their own interest."[2] In the railroad field, it is reported that the Transportation Act of 1940, with its declaration of a national transportation policy, was developed by the organized railroads. Its final enactment by Congress is said to have represented "the successful termination of a long and costly propaganda and lobbying campaign by the railroads." The Reed-Bulwinkle Act (1948), exempting surface carriers from the antitrust laws in their rate-making activities, is a further example of legislation formulated by the organized railroads.

The electric utilities have been especially active in endeavoring to shape public policy along lines favorable to their interests. According to the study on political pressures prepared for the TNEC, "Either through their trade association, the Edison Electric Institute, or through informal groups such as the Committee of Public Utility Executives, the electrical utilities have engaged in extensive legislative lobbying, have resorted to the courts when legislative lobbying failed, and, in addition, have made use of widespread propaganda for their general economic philosophy."[3] There is evidence to indicate that this extensive political activity is being continued.[4]

A special study by the Federal Trade Commission found that the electric utilities have actively endeavored to instill in the minds of the general public a point of view which is favorable to the private ownership of local utilities. Their objectives, the report declares, have been (1) "to inculcate in the public full belief in the right of the privately owned utilities exclusively to occupy the utility field," and (2) to oppose public ownership and operation "even to the point of characterizing . . . exponents as public enemies."[5]

In carrying out their propaganda activities, the Commission found that the utilities have conducted a great variety of public relations activities. These have included (1) the building up of good will and friendly relations with the press by means of "consistent and substantial advertising"; (2) an attempt to mold the minds of educators and students, from kindergarten to the college level, by giving endowments, scholarships, free books, payments to teachers and school officials, and by an editing of textbooks; and (3) an effort "to make impregnable the wall around private business" by selling securities to customers and employees. The general point of view taken in these activities, it is said, has been that if the public can be inculcated with ideas favorable to the industry, the political demand for more stringent regulatory control can be minimized or eliminated. In the words of Samuel Insull, an organizer of large utility holding companies, "The politician gets

[2] *Economic Power and Political Pressures,* Monograph 26, Temporary National Economic Committee, 76th Congress, third session, 1941, p. 145.

[3] *Ibid.*, p. 152.

[4] For current data on the largest spenders registered under the Federal Lobbying Act, see the publication *Congressional Quarterly, Weekly Report.*

[5] Summary Report of the Federal Trade Commission, *Utility Corporations,* 70th Congress, first session, Senate Document 92, 1934, Part 71A, p. 8.

into office by attacking utilities. . . . He would not do that if the public was friendly to the utilities."

In concluding its report on the public relations work of the organized electric utilities, the FTC states: "The total results which have been secured from all the various activities cannot be measured. But to such an extent has the utility program taken into consideration '*every public contact*' that no campaign approaching it in magnitude has ever been conducted except possibly by governments in wartime. The various utility associations have collected and disbursed probably more money for good will publicity purposes than has been secured or paid out by any other group or organization. . . ."[6]

Influence on the Commissions. A further problem in commission control is the influence which private industry groups exert on the appointment, confirmation, and decisions of members of the commissions. Prospective members, first of all, are selected by politicians for political reasons, such as assistance in political campaigns, financial contributions, and the support of organized groups. Upon being nominated by the President, a commissioner must be confirmed by the Senate. It is at this stage, in particular, that organized producers bring their influence to bear against anyone who is, or who might be, unsympathetic to their interests. If a nominee is confirmed as a commissioner, he finds himself subject to continuing pressures from industry groups. Day after day he hears about *their plight*, and it is easy for him to lose perspective on the purpose of regulation. He quickly comes to realize that he is not smart enough to manage the regulated concerns, and he usually does not want to make a mistake with other people's money. Increasingly, experience shows, his concern shifts from the public interest to that of the well-being of the regulated industry.

Shippers and industrial users rarely provide much resistance to higher rates and charges. As long as their competitors must pay the same rates, and no one gets an advantage, they tolerate or accept the established rates. Their own pocketbook is not at stake, for their practice is to pass the higher charges on to consumers.

Numerous authorities have developed the thesis that there is a strong tendency for the utility commissions to become a defender of the industries controlled. Professor S. P. Huntington, for example, concludes that the Interstate Commerce Commission has become an agency *for* the railroads and has turned more and more to the railroads *for its support.* In his view, the ICC has lost its objectivity and its impartiality.[7] Professor Walter Adams similarly calls attention to "the tendency of many commissioners to identify so closely with the industries they regulate, that the 'regulatees wind up doing the regulating.' In its mildest form, such identification results

[6] *Ibid.*, pp. 17–18.

[7] S. P. Huntington, "The Marasmus of the ICC," *Yale Law Journal*, April, 1952, pp. 467–509.

in subordination of the public interest to private privilege; in its most virulent form, it results in influence peddling and corruption."[8]

THE VIEW THAT COMMISSION CONTROL HAS PROVED TO BE INEFFECTIVE

There is a considerable body of opinion that commission control has not proved to be an effective mechanism for protecting the public interest. The governmental agencies, it is pointed out, are frequently undermanned; suffer from an inadequate budget; are lacking in qualified personnel; and frequently appear to be more sympathetic to the regulated industry than to consumers. The reasons for this situation, it is said, are to be found in the technical problems of control and in the political pressures which have been employed to weaken and, at times, to frustrate control. Basically, public utility type commission control is an ineffective kind of regulation. Economic concentration has made it more so.

A study of the electric power industry, prepared under the auspices of the Twentieth Century Fund, a nonprofit foundation for economic research, concludes that under the state commissions many electric utilities have been permitted to earn unreasonably high profits. "There is a basis," declares the report, "for the widespread feeling (which reached a climax in several state legislatures about 1930) that state regulation in general has failed to achieve its primary purpose."[9]

Similarly, John Bauer and Peter Costello, recognized authorities on public utilities, conclude that "altogether state regulation has looked pretty hopeless as a means of holding private monopoly to its public functions. It has had to work under impossible restrictions and requirements, and under other strangling circumstances. Occasionally, some commission undertook to cut through the entanglements, but none ever succeeded in beating the system to which it was consigned. An occasional commissioner started with zeal to reform the methods, but his efforts were frustrated by the legal and procedural incrustations, the weight of inertia, utility influences, and the accumulations of resistance to public needs."[10]

developed or are frequently found to exist, government should adopt commission control to prevent extortion. This proposal is invariably frowned upon by many economists. All too often, they observe, the mechanisms adopted to prevent price increases have been turned into mechanisms for protecting industry and insuring the prevention of price decreases.

Professor Fritz Machlup, in commenting on a proposal to extend public price fixing to the concentrated industries, particularly steel, has said:

> Yes, I am familiar with these plans, and, if you don't mind, I am skeptical. I am not in favor of price controls or price regulations of any sort. I grant you that in so-called public utilities, regulation is necessary, because these are inevitable monopolies. There cannot be competition in these fields, and hence we have taken it upon us to regulate prices there in order to protect the consumer.
>
> But even there, what was the outcome? In many of these fields where we started regulating prices for the benefit of the consumer, we have, after a while, changed things so that we would regulate prices to the disadvantage of the consumer.
>
> I believe there is hardly a field in the American economy that is worse with regard to monopolistic restraints than transportation. This was the first industry which we started to regulate. We have been regulating freight rates since 1887, when the Interstate Commerce Act was enacted. We have been regulating ever since, and what have we achieved? We have suppressed competition, we have prevented prices from getting lower, and we are still doing it. We enacted later the Motor Carriers Act, and then the Transportation Act, and I think there is no industry in the United States that is worse than our transportation industry, as far as monopolistic restrictions and suppression of competition are concerned."[11]

The most effective kind of regulation for a private-enterprise economy, experience has shown, is that provided by competition. Sound public policy, therefore, calls for a strengthening of antitrust law enforcement and persistent efforts to maintain competitive conditions.

If experience shows that competitive conditions cannot be maintained in a given line of business, the American people are confronted with a difficult choice. The alternatives are (1) the acceptance and toleration of private monopoly, (2) an attempt to achieve an improved form of commission control (regulatory commissions free from improper political pressures), or (3) the adoption of public ownership (a public corporation) or a consumer-controlled (cooperative) system.

GOVERNMENT OWNERSHIP AND OPERATION AS AN ALTERNATIVE TO COMMISSION CONTROL

The economic and political difficulties involved in commission control, as well as the existence of certain businesses characterized in some degree

[11] *Administered Prices*, Committee on the Judiciary, United States Senate, 86th Congress, first session, 1959, Part 10, p. 4965.

by monopoly, have caused various economists and statesmen to advocate a widening use of public ownership.[12]

In considering public ownership as a control device, it may be observed, first of all, that the proposal is exceedingly difficult to discuss without prejudice. Joseph B. Eastman, a long-time member of the Interstate Commerce Commission, has said:

> Aside from religion, there is perhaps nothing that so excites prejudice as the fear of being separated from the opportunity for profit. Under public ownership and operation of railroads and other public utilities, the field for profit on the part of bankers would unquestionably be curtailed very materially. The officers of the private companies fear that they would be displaced or their salaries reduced. Certain of the directors may fear the loss of the lucrative opportunities which grow out of advance knowledge of coming corporate events. Those who furnish the private companies with supplies or services, often under the generous guardianship of holding companies, fear interference with existing profitable relationships. . . . All of these, and many others which might be mentioned, are sources of prejudice, conscious or unconscious, against which those who wish to think soundly must be on their guard. . . . A belief or disbelief in public ownership and operation has in fact become a shibboleth by which the conservative test political and economic sanity.[13]

PUBLIC OPERATION NOT ALWAYS GUIDED BY YARDSTICK OF COMMERCIAL PROFIT

Secondly, in discussing public ownership, it should be noted that government owns and operates a variety of productive undertakings *for reasons other than business profit*. Government ownership of forests, public lands, hydroelectric dams, and reclamation facilities is undertaken to conserve and develop our natural resources. Historically, the postal system has been operated to aid in developing the commercial and social life of the nation. During World War I, the federal government operated the railroads as a national defense measure, and from that standpoint the operation was eminently successful.

In certain instances, government ownership and operation are also adopted because of the inability of private enterprise to render an essential public service. The Alaska Railroad and numerous municipal electric, bus, and

[12] See, for example, Henry C. Simons, *Economic Policy for a Free Society* (Chicago, 1948), pp. 61–62, 195; Clifford L. James, "Commons on Institutional Economics," *American Economic Review*, March, 1937, pp. 61–75; Joseph B. Eastman, "A Plan for Public Ownership and Operation," *Annals of the American Academy of Political and Social Science*, January, 1932, pp. 112–119; and E. Davies, *National Enterprise* (London, 1946), p. 16. A list of arguments advanced in Great Britain for nationalization are presented by Ben W. Lewis in *British Planning and Nationalization* (New York, 1952), pp. 43–45.

[13] National Association of Railroad and Utilities Commissioners, *Proceedings for 1927* (New York, 1928), pp. 365–366.

street railway systems, for example, were undertaken as private ventures and then taken over by government because they proved to be unprofitable. In some cases, with the growth of the community, such enterprises have become profitable. However, in other cases, such as the Alaska Railroad, the enterprises have continued to be unprofitable.

Since government operation in the foregoing situations, as well as in many others, is conducted for reasons other than profit, it follows that the success or failure of government operation cannot be measured only by the yardstick of commercial profit.

PUBLIC OWNERSHIP PROPOSALS USUALLY LIMITED TO AREAS OF PRIVATE MONOPOLY

Thirdly, in discussing public ownership, it may be noted that the principal segment of business activity which various economists and citizens believe should be placed in government hands consists of highly essential business in which monopoly is (1) "natural" or (2) strongly established. In the case of "public utilities," in the narrow sense, public ownership is usually proposed when it is believed that commission control is ineffective or where the enterprise under private ownership is a failing enterprise—such as a street railway. Businesses in the public utility category include electric power, gas (manufactured and natural), water, urban mass transportation, telephone communications, telegraph systems, railroads, intercity buses, motor transport, airlines, and oil pipelines.

Some economists also propose that government ownership and operation be extended to other essential industries, such as the steel industry, in which there is a condition of economic concentration and anticompetitive behavior. In such industries, it is believed, price competition cannot or will not be created. Professor Ben W. Lewis, for example, declares: "I have come to believe . . . that these laws [antitrust laws] now represent a rear-guard (albeit, a very important rear-guard) action; and that in the years ahead a considerable and increasing portion of our economy will come to be controlled through conscious public action (probably public enterprise) rather than by the 'automatic' processes of competition bolstered by the Sherman Law." [14]

Professor Lewis further observes that the "dilution and weakening of competition as a compelling regulatory force" extends to a considerable area of our economy. In his words,

> Some indication of the looseness of the regulatory force of competition in mass production industry is to be found in the exhortations increasingly

[14] Ben W. Lewis, "The Antitrust Laws: A Symposium," *American Economic Review*, June, 1949, p. 704. This point of view was reaffirmed by Professor Lewis in "Comments on the Teaching of Economics," *American Economic Review, Papers and Proceedings*, May, 1951, p. 714.

being delivered by economists, public officials, and "enlightened" business leaders, urging managements to shape their price, output, wage and investment policies in accordance with long-run, over-all social considerations: increased purchasing power and consumption, full employment, an economy of plenty, etc. If competition, actual or potential, were really effective, these exhortations would be quite uncalled for and wholly useless. Need I add that as a prime regulatory instrument in our economy exhortations would seem to leave much to be desired? Something more certain in its promise and compelling in its force than an appeal to the good will and social consciousness of business leaders is called for in economic situations where sound criteria of individual and corporate gain run directly counter to sound criteria of general economic welfare.[15]

The Committee on Cartels and Monopoly, appointed by the Twentieth Century Fund, and composed of outstanding men in business, law, and economics, concludes that commission control "has not been so successful as to justify a similar prescription for all industries in which the degree of concentration destroys the effectiveness of competition." The Committee, in fact, frankly declares:

> If the state is to take over in large part the function of making managerial decisions, the question arises whether it would not be more efficient and economical to socialize the regulated enterprise. Duplication of functions could thus be avoided, the cost of litigation eliminated, and authority and responsibility combined. Where a high degree of concentration of control over physical operations is an accomplished fact, the most formidable obstacles to socialization have already been overcome. The transfer of control to public officials can be accomplished by the simple process of acquiring a majority of the voting stock. It is noteworthy that proposals for nationalization are more often concerned with industries in which firms are few in number and large in size than with those in which firms are numerous and small. It is a sound instinct that has led socialists consistently to oppose the policy of antitrust.[16]

THE VIEW THAT PRIVATE MONOPOLY LEADS TO NATIONALIZATION

The main idea underlying the thesis that public ownership sooner or later should—or probably will—be adopted to replace monopolistic control in various sectors of *general* industry is based upon the belief that government will not take significant action to dissolve economic concentration. In the words of Ben W. Lewis, "The way is effectively and permanently barred by the presence—the increasing presence—of large-scale industrial, marketing and labor units. We will not reduce their scale in any significant measure."[17]

[15] *Ibid.*, pp. 707–708.
[16] Twentieth Century Fund, *Monopoly and Free Enterprise* (New York, 1951), p. 549.
[17] Lewis, *op. cit.*, p. 707.

Various reasons are suggested for the view that government will not act to dissolve the large financial combinations. They include (1) the political influence of the giant corporations and their lavish expenditures to defeat the enforcement of the Sherman Act; (2) the apathy of labor groups generally to a revitalization of the antitrust laws; (3) the general satisfaction of farm groups with subsidy and price-support plans to offset the disparity between farm and industrial prices; (4) the interest of many small business firms in securing special legislation, financial assistance, and tax benefits "to balance the scales"; (5) the ignorance of many people with respect to the measures which government must adopt to implement a plan of competition; (6) the mistaken notion that monopoly is inevitable in the basic manufacturing industries because of technological factors; (7) the popular acceptance of the view that our present-day economy *is* a fully competitive system; and (8) the favorable attitude of the Department of Defense toward big business.

In so far as Congress and the American people accept monopoly in an ever widening range of the American economy, it is believed by many that capitalism will become increasingly unworkable. The experience of the great depression, following the extensive merger movement of 1920–1929, showed that monopolistic industry in a depression "stabilizes" prices at high levels, despite the fact that other prices have fallen. Output and employment in the monopolistic industries are sharply curbed, and buying power is constricted. Serious price disparities develop between the monopolistic industries and those which are free.

If a prolonged depression should occur, it is believed by some authorities that a large number of American people will increasingly look to government for jobs and security of income. In attempting to provide jobs, it is pointed out that government may be forced to take over several of the basic industries, such as steel, fuel, and transportation, for government has no authority to compel private enterprises to invest capital, employ men, or sell their products at low prices.

THE PROPOSAL SUGGESTED FOR OVERCOMING WEAKNESSES OF PUBLIC OWNERSHIP

In an effort to correct or overcome the shortcomings attributed to public enterprise, persons believing in that form of control propose that *government corporations* be created to own and operate the firms to be nationalized. Thus, Joseph B. Eastman, long-time advocate of public ownership of the railroads, states:

It seems clear to me that public operation of an industry or business ought not to be handled in ordinary routine by a government bureau or department, nor should it be merged with the ordinary civil service. On the contrary, it should be kept separate and handled on a strict self-sup-

porting basis by a business corporation organized in the usual way but controlled through stock ownership by the government. Its affairs should be directed, like those of any other business corporation, by a board of directors chosen by the government, as the controlling stockholder. . . . such a plan makes it possible to carry on the business in much the same manner as it would be carried on by a private business corporation.[18]

Government-owned corporations, in fact, have come to be extensively used for conducting various public enterprises. Important federal corporations include the Alaska Rural Rehabilitation Corporation, Commodity Credit Corporation, Federal Crop Insurance Corporation, Federal Deposit Insurance Corporation, Federal Farm Mortgage Corporation, Federal Savings and Loan Insurance Corporation, Home Owners' Loan Corporation, Inland Waterways Corporation, Virgin Islands Corporation, Tennessee Valley Authority, and Federal Prison Industries, Inc.

Public corporations owned by the federal government are initially financed by the issuance of capital stock to the Treasury Department in exchange for funds. Their management is vested in a board of directors appointed by the President by and with the consent of the Senate, and reports are made to Congress through the President. Public corporations owned by local, county, or state governments are similarly financed and controlled by their respective governmental units.

Persons advocating public ownership of particular economic activities believe that public corporations are highly effective devices for conducting such enterprises. President Truman, in his message to Congress on January 3, 1947, for example, reported as follows: "Experience indicates that the corporate form of organization is peculiarly adapted to the administration of governmental programs which are predominantly of a commercial character—those which are revenue producing, are at least potentially self-sustaining, and involve a large number of business-type transactions with the public. In their business operations such programs require greater flexibility than the customary type of appropriation budget ordinarily permits. As a rule the usefulness of a corporation lies in its ability to deal with the public in the manner employed by private business for similar work."

INTEREST IN PUBLIC OWNERSHIP NOW CENTERS IN ELECTRIC POWER

Throughout the nation there is a growing demand for abundant supplies of cheap electricity. In the opinion of some authorities, as we have seen, commission control has failed to provide this end result. At the same time, particularly since 1935, publicly owned and consumer-controlled power systems have built an enviable record in providing plentiful supplies of elec-

[18] National Association of Railroad and Utilities Commissioners, *Proceedings for 1927* (New York, 1928), p. 371.

tricity at rates which are typically below the rates of private utilities.[19] How is this to be explained? Is public power the appropriate alternative to commission control?

The relative importance of (1) *privately owned* power enterprises and (2) *publicly owned* systems and *consumer-controlled* local agencies (cooperatives) is shown in Table 31. Publicly owned power systems include (1) federal power projects, such as TVA, Bonneville Dam, and Grand Coulee Dam; (2) municipal corporations; (3) state-owned utilities, such as the Grand River Dam Authority in Oklahoma; and (4) public utility districts (public corporations) with authority to generate, transmit, and distribute electricity within designated areas, such as the Grant County, Washington, district with the large Priest Rapids and Wanapum projects.

In addition to the publicly owned systems, there are the rural electric cooperatives in which ownership is credited to individuals. The Rural Electrification Act of 1936 authorizes the making of federal loans to farm cooperatives for the construction and operation of generating plants, transmission lines, and distribution systems. Rural electric cooperatives can borrow 100 percent of their investment capital from the federal government, at 2 percent interest, with repayment to be made over a period of thirty-five years.

TABLE 31. Electric Utility Generation and Sales of Electric Energy in the United States, 1953–1958

	Net Generation			Sales to Ultimate Customers		
Year	100 Kwh	Percent Private	Percent Public and Cooperative	1000 Kwh	Percent Private	Percent Public and Cooperative
1942	185,979,476	85.0	15.0	165,431,120	86.9	13.1
1947	255,738,984	81.4	18.6	223,688,095	83.2	16.8
1951	370,672,814	81.4	18.6	325,747,566	82.0	18.0
1952	399,223,620	80.7	19.3	350,384,865	81.5	18.5
1953	442,664,515	80.0	20.0	384,244,000	81.1	18.9
1954	471,686,354	78.6	21.4	410,904,000	79.2	20.8
1955	547,037,985	76.9	23.1	480,921,000	77.0	23.0
1956	600,667,750	76.4	23.6	530,128,000	76.8	23.2
1957	631,507,224	76.2	23.8	557,829,000	76.8	23.2
1958	645,098,404	76.0	24.0	569,161,000	77.2	22.8

SOURCE: Federal Power Commission.

THE CONTROVERSY OVER PUBLIC POWER

It is important to note that any comparison of public power with private power must be subject to numerous qualifications. Most publicly owned

[19] See Federal Power Commission, *Typical Electric Bills, Cities of 50,000 Population and More;* and *Typical Residential Electric Bills, Cities of 2,500 Population and More,* published annually.

generating plants are based on water power, whereas privately owned plants are usually operated by steam power. Steam power is generally more expensive than water power. In specific cases, however, this depends upon the characteristics of the hydro site developed and upon the cost of money and fuel. Some hydro sites cost much more to develop than others. As the best hydro sites were developed long ago, those presently under consideration for development are mostly high-cost sites.

The capital cost of constructing hydro plants is generally substantially greater than the capital cost of steam plants of equivalent capacity. The cost of power from hydro plants is determined by the aggregate capital cost multiplied by the rate of interest used as compared with these same factors plus the annual cost of fuel for a steam plant. When these annual costs are related to the annual amounts of power produced, the result is the cost of power for each plant. From this it will be evident that a lower rate of interest (because of tax-exempt bonds) in the case of a publicly owned hydro plant will have a marked effect on the apparent cost of power produced. Of course, if a multiple-purpose hydro project is under consideration, a fair cost of power can only be computed if the correct amount of the capital cost is assigned to power. In making cost allocations for multiple-purpose projects, such as Bonneville and Grand Coulee, controversy arises over the percentage of the cost (45, 50, or 90 percent) which should be charged to power.

There is a further factor which must be considered in comparing hydro and steam plants. They operate very differently. The flow of water varies from day to day, season to season, and from year to year. These fluctuations limit the amount of hydro power which can be produced, but have nothing whatever to do with customers demand for power. Low water and consequent minimum production of power may occur at a period of peak customer demand. Steam plants, on the other hand, are regulated to produce power when customers need it. Sooner or later hydro projects must be backed up with steam power in order that the demands of the customers may be met with reliability. Some private and public plants serve cities in which population is dense and per capita distribution costs are low, while others serve rural areas in which distribution costs are high and customers are few.

Arguments Presented by Public Power Advocates

1. The purpose of public power is to provide electricity at the lowest possible rates, so that electric living will be within the reach of all. The rates of public power systems are typically below the rates of private

Arguments Presented by Private Power Advocates

1. Investor-owned public utility companies provide electricity at the lowest possible rates in line with the predominantly retail character of their services, their operating costs and taxes, and the annual cost of the

utilities. Many public systems sell electricity for residential use at rates under 1¢ per kilowatt-hour. This rate is fully 60 percent below the average residential rate in the United States. The average consumer of public power also uses more electricity than the consumer of private power.

Public power is a creature of the state. The bonds of states and municipalities are for public purposes. State and city activity has long been immune from federal taxation. This is a sovereign right in accord with the Constitution.

Public power should be given credit for contributions made to state and local governments in lieu of local taxes. Contributions and free services are in line with state and local taxes paid by private utilities.

money which has been invested in them.

The lower rates charged by publicly owned utilities are to be explained primarily by special tax advantages: (1) no federal income tax on public power systems and (2) no federal tax on the interest of state and municipal bonds. These savings do not represent social gains. Rate comparisons are totally misleading, for all true costs are not considered.

The product of government projects and cooperatives has no inherent advantage save preferential treatment from the federal and other governments. The savings afforded in this way are not social gains but are loaded on the backs of customers of investor-owned public utility companies.

State and federal commissions control the rates of investor-owned public utility companies, and the price of their service carries its full share of taxes, both federal and local.

2. Publicly owned systems are able to borrow money at very low rates because the basic risks are less and the bonds are tax exempt. They retire their indebtedness and do not continue paying interest to others.

Because of heavy investment in plant, the annual cost of capital is a substantial element in the cost of power. Private companies are allowed a "fair return" of 6 to 7½ percent on the investment used and useful in the public service. Public power pays interest only on its outstanding bonded indebtedness. Consequently, capital return requirements of a publicly owned system are considerably less than under private ownership.

Public agencies typically finance normal plant expansion and retire debt out of earnings. Bonded indebtedness is continually being decreased.

2. It is true that government-owned projects can borrow money at lower interest rates than investor-owned public utility companies. Nonfederal government projects, such as municipalities and public utility districts, are privileged to issue bonds which are exempt from federal and state income taxes. This is tax avoidance. It is an unfair tax advantage.

Any lower interest costs by reason of governmental ownership are purely the result of avoidance of taxes or other subsidy which must be made up concurrently by someone else. Persons receiving government power do not pay for the full cost thereof. Government projects and rural electric cooperatives ride on the backs of others. Also, people who do not have money to buy tax-exempt bonds must pay higher taxes

Interest costs decline proportionately. When entirely debt-free, there are no interest charges at all; and rates can be reduced to cover only operating costs and depreciation.

because governments receive less tax revenue from those who buy the bonds.

3. The objective of public power is the provision of electricity at cost—without profit. Publicly owned systems are self-supporting. They make a full return of the investment, together with interest.

In public power, the customer and owner are one and the same. Management has no divided loyalty. It can concentrate on giving good service at the lowest possible cost. Public power managers, being public figures, have more of an incentive to do a good job for the consumer than the managers of a privately owned utility.

3. The objective of investor-owned public utility companies is to provide power at the lowest possible rates consistent with good service and sound economic principles. The tenure of management of investor-owned public utility companies is dependent on rendering good service at reasonable prices and on its ability to maintain reasonable earnings for security holders. Any management failing in this responsibility is immediately accountable to customers, to regulatory bodies, to stockholders or creditors, or all four. Government power has no such checks and balances. Government power decisions are not under similar regulation and scrutiny.

4. Publicly owned systems do not spend millions of dollars for propaganda, lobbying, and political activity, radio programs, and advertisements on the dangers of "creeping socialism," as have the private power companies. Publicly owned utilities also save the high costs of legal and other experts hired to fight rate increases through the commissions and courts.

4. Public utility companies in their efforts to combat misleading government power and cooperative power propaganda are fighting for their very existence in attempting to halt the spreading of government power and cooperative power. In so doing they are serving the best interest of the public by providing factual information about political ownership and tax avoidance.

5. Publicly owned systems do not have to pay federal corporate income taxes on business profits, because they do not seek to make an income return on capital investment. Taxes are saved (not avoided) because public power is not operated for a return on equity capital.

Net earnings over costs, depreciation, and state and local taxes are

5. The exemption of public power systems from federal income taxes eliminates this logical source of federal tax revenue. Consumers served by government projects and cooperatives avoid their fair share of the federal tax burden. They do not carry any local taxes in many cases or less than their fair share in others. These burdens are transferred to

used to retire debt and build new plant capacity.

Taxes saved by the publicly owned utility are not lost to the federal government. The savings in power costs by commercial and industrial customers increase their taxable income by that amount, and the government gets its taxes through them.

Public power provides *direct* public benefits (cheap electricity) to consumers. It promotes industry and employment and results in a greater tax base. Public power serves at cost, and any surplus goes to benefit rate payers through rate reductions or through plowing back in capital expenditures.

other payers of taxes. This is clearly inequitable.

Government projects and cooperatives should carry their full share of the cost burden and pay their full share of taxes. When we give special privilege in subsidized interest charges and avoidance of taxes to certain groups, we are furthering a policy of discrimination and preference which has no proper place in America today. Our economy cannot long survive at the present high level of taxation if specially favored groups avoid their fair share of the tax burden while others carry more than their share.

In order to make the tax burden fair, government power should not be spread. Government should regulate, not operate, business.

6. Publicly owned utilities have lower operating expenses. Operating costs are a basic measure of efficiency. Studies made by the Federal Power Commission and private experts show that unit costs for business expenses—accounting, collecting, advertising, sales promotion, and administration—are less for publicly owned utilities. Lower total costs also result from higher consumption due to lower rates.

There is no authoritative evidence that either public power or private power has an edge on the other with respect to the over-all quality of service. In general, quality of service is more likely to be a function of size, natural conditions, and financial strength, rather than of ownership.

6. Operating expenses of government-owned and cooperative power projects vary widely, as their accounting is not regulated and standardized as is the accounting of investor-owned public utility companies.

When lower operating expenses (other than taxes and interest) occur in the case of government-owned retail distribution systems, they commonly reflect vagaries of the accounting system used or inadequate or inferior service—such as poor voltage regulation, more frequent interruptions in service, and inattention to the needs of customers. Anyone can reduce operating costs by such methods, but investor-owned public utility companies cannot gamble on failing to serve the public adequately or in failing to keep accurate cost and income records.

7. Public systems are coordinated much better than the private with the various other governmental ac-

7. Integration of generating plants and distribution facilities through transmission lines (power pooling)

tivities—for example, the placing and maintenance of distribution facilities on the streets. They are also better integrated with other public power systems and so entail superior economy, both in capital requirements and operating expenses. In the TVA program, for example, generation and distribution are directly integrated with the many municipal and cooperative distribution systems. The Bonneville and Grand Coulee power systems are also integrated with the Washington and Oregon public utility districts.

8. Unified *regional* development has maximum public advantages. Public hydro power is naturally a joint product of a comprehensive river-valley development that almost always combines flood control, soil conservation, reforestation, recreational facilities and sometimes river transportation, irrigation, and municipal water supplies. Power can thus be supplied most economically through unified multiple-purpose systems, planned and carried through by the federal government in close cooperation with state and local interests. No such over-all economy or total public advantage is available through private power organization.

If power is separated from a multiple-purpose project and is turned over to private undertaking, there will be (1) enhanced capital outlays and operating costs not only for power but also for the other related functions continued under public organization and (2) reduced potentials for advantageous integration of power production with the other river-valley objectives. There will be a material loss of total regional and national benefits. This will be true of any large river system.

was first developed by investor-owned utility companies. Its object is to permit the use of the lowest-cost generation available to the pool at all times. This power is shifted from one locality to another to meet varying daily or seasonal needs and to back up loads in case of equipment failure or inadequate water. The result has been that all customers have obtained better service at lower cost.

8. In some cases in which river-valley developments involve flood control, navigation, or irrigation, the entire project cannot be developed by investor-owned companies without compensation for the portions of the projects which are built on the basis of public policy rather than on a self-supporting basis. In cases in which such multiple projects are developed by federal agencies, either falling water at their dams or electric power from their generators at the "bus bar" should be sold to investor-owned public utility companies. In any event, these companies should transmit and distribute the power produced to customers within the economic marketing area, subject to rate control by regulatory commissions. Electric power facilities which are worth developing can be built by investor-owned public utility companies either by themselves or in partnership with federal or state bodies.

Investor-owned utilities do and can exist and render valuable public service within the river-valley projects. In the Hoover Dam project, for example, private power distributes and provides a market for federal power.

SOME GENERALIZATIONS ON PUBLIC AND PRIVATE POWER

In the utility field, the institutions of price competition and freedom of entry do not exist to protect consumers. A system of government control has been built up in place of this competitive mechanism. In order to avoid needless and expensive duplication of facilities, it has become the general practice for governments to assign utilities limited geographical areas in which to operate. These are known as franchise areas. Generally only one electric franchise is issued for each individual area. Thus, electric utilities are sometimes called "natural" monopolies. They should not be thought of as economic monopolies, however. Economic monopolies have the right to regulate their output and their price in such a way as to maximize their profit. This private power utilities do not have. Regulatory bodies control their rates and supervise their service, investments, and accounts. In the cases of government-owned projects and cooperatives, commission control is not applied, on the ground that their purpose is to sell electricity at the lowest possible rates.

Government ownership and operation of power facilities, it may be noted, does not always mean lower rates. A municipally owned utility is commonly restricted by law in its operations to an area within the limits of a town. It is usually, moreover, not permitted to merge with, acquire, or combine with other utility enterprises. Thus, many municipal utilities are unable to secure the economies of large-scale generation and transmission. Isolated as they are in a local community, they frequently are not in a position to take advantage of the best technology.

In general, however, the rates for government-owned projects are lower than those for private power. The cheaper rates for public power arise mainly from (1) the lower tax burden of public power and (2) its lower interest cost on borrowed capital.

State and Local Tax Burdens

Private utilities contend that publicly owned utilities do not pay their fair share of the local tax burden, because their properties, in the main, are not assessed for property taxes. In their view, this statement is borne out by data published by the Federal Power Commission which shows for non-federal projects payments in lieu of taxes of 3 percent of revenue. This compares with a figure for local taxes of 9 percent of revenue paid by private utilities. Some local distributing companies owned by municipalities, however, provide other services and make other payments to their owners which may be considered as a further offset to the taxes they do not have to pay.

Municipal utilities and public utility districts typically pay state taxes

on gross revenues from retail sales, state sales taxes, regular state business taxes, state gasoline taxes, state generating license fees, and industrial insurance, in line with those paid by privately owned utilities. They also usually pay local business and occupation taxes and local franchise taxes. It is common for publicly owned enterprises to furnish services, such as street lighting, at little or no cost. On some occasions, moreover, they pay special gross-revenue taxes or make cash contributions to state and local agencies in lieu of property taxes. It has been urged that the value of such payments and services may fully offset the property tax burden which privately owned utilities must pay.

Various economists have suggested that it would be desirable to prepare careful records of all state and local taxes paid by private and public enterprises, including all payments and services rendered in lieu of taxes. Such a practice would make it possible to compare costs and state and local tax burdens in a more accurate way.

Federal Income Tax Payments

Private utilities also complain that publicly owned systems do not have to pay federal corporate income taxes on business profits. Public power, it is said, thus avoids its share of the national tax burden as found in the corporate net income tax.

From an economic viewpoint, should the federal government impose a tax on the net earnings of publicly owned utilities? Some believe that if a public agency renders a *commercial-type* activity—i.e., the sale of electricity—the users should contribute to the cost of the national government. By equalizing the burdens of publicly and privately owned utilities, moreover, it is said, managerial efficiency and product rates can be more accurately compared. Others declare that under modern conditions the supplying of electric power has become basically a *governmental function.* The fundamental importance of electric power in modern life, together with its monopoly status, they affirm, places its production properly within the scope of government, like the provision of police and fire protection, water, streets, and sewers. Such activities, it is recognized, are not expected to contribute to the cost of the national government. As a further point, public power advocates declare that the social consequences of cheap power in making possible a higher level of living and a dynamic expanding capitalism are far more important than the possible payments of corporate net income taxes.

Federal income taxation on public power systems also is believed to be repugnant to the federal Constitution because of state sovereignty. Public power advocates declare that it has been judicially established ever since *McCulloch* v. *Maryland*, 4 Wheat. 316 (1819) that both the federal and state governments are protected, as sovereign states, against taxation of their property and revenues by the other.

The Issuance of Tax-Exempt Securities

The main economic argument for the issuance of tax-exempt securities is that a governmental body is thereby able to borrow at lower rates of interest. This argument is undoubtedly true. With a system of progressive income taxes, however, the loss in tax revenue from persons with high incomes who buy such securities possibly is greater than the saving in interest cost. A glance at the advertisements for tax-exempt securities will show that persons with high incomes investing in tax-exempt securities possibly are able to secure a higher net return on their capital than persons of moderate means who buy defense savings bonds. The practice of tax exemption may consequently serve to benefit persons of wealth more than the borrowing public.

Public power proponents affirm that a federal tax on state, county, and municipal bond interest would be unconstitutional. Securities issued by states, counties, municipalities, and their "districts" and "authorities" have been declared instrumentalities of government which Congress—another sovereign power—cannot tax.[20]

A CHOICE FOR THE PEOPLE

Today, private power interests are working actively to check the further growth of public power systems. At the same time they are seeking to remove the competitive aspects of public power by raising its costs to the level of private power. This they hope to do by (1) proposals to impose a federal tax on the interest of municipal, county, and state bonds—which historically have been tax-exempt; and (2) proposals to place a federal income tax on public power systems—a form of taxation which has been considered to be unconstitutional. These proposals are being advanced in the House Ways and Means Committee, the congressional committee which originates tax legislation.

The position of the private power interests is that public power should pay the same costs that are paid by private power. They ask the question "Is it morally right for the people served by investor-owned utility companies to pay for (1) the full cost of their own power and (2) part of the cost of the power for customers of government-owned projects and cooperatives as well?"

The public power advocates, on the other hand, take the position that public power and private power are basically two different animals—two different institutions. It is a mistake, they contend, to try to make public power into the same kind of animal as private power.

Public power, it is stated, is a public business. It has the public for its stockholders. Its purpose is the provision of electricity at cost without

[20] *Pollock* v. *Farmers Loan and Trust Co.*, 157 U.S. 429 and 158 U.S. 601 (1895).

profit. It is a creature of the state—a sovereign state—brought into being to provide a highly essential public service. It is a public business like the provision of sewers, bridges, and roads. These activities of government are not expected to pay a tax to the federal government—or to be operated for a profit like a commercial enterprise. It would be a mistake to change the purpose and nature of a public business.

Public power systems are operated as a business with accounting systems to recover costs. This, however, it is stated, does not change the basic fact that public power is a creature of the state—not a group of private stockholders—and is a public business. The provision of water and sewer service is similarly conducted as a public business.

Electricity, public power advocates believe, is so essential in modern-day living that it should be operated as a public business. Public power does not pay all of the taxes which private power must pay. However, it is emphasized, the people get benefits from their ownership which are socially tremendous. The electric rates in a number of public power systems are around one-half of the national average, and the people consume some two and one-half times as much electricity. Public power thus provides a very much higher level of living. What it would cost a private company to provide roads, bridges, or sewer service is not important. There is no sound basis, say public power supporters, for taking action to increase the costs of providing an essential public service. Public power should not be made the same kind of animal as private power.

23

Regulation of the General Level of Economic Activity

Since World War II, there has developed in the United States widespread acceptance of governmental responsibility for the maintenance of high employment, reasonable stability of the general price level, and a rising level of production. In the present chapter we shall study the policies adopted by government to fulfill this responsibility.

In the past the federal government has largely sought to promote maximum output through the institutions of free entry and price competition. The assumption has been that if government provides a fair and open field, private enterprise will invest capital and offer maximum employment opportunities.

The coming of the great depression, with its unprecedented mass unemployment, shook the faith of millions of people in our free-enterprise economy. Jobs and income became paramount in their thinking, and for this need they turned their attention to government.

The change in thinking on the responsibility of government reflects a change in underlying economic conditions. Since the adoption of the antitrust laws, as we have seen in the preceding chapters, the federal and state governments have largely failed to provide effective enforcement. In important areas, business now lacks its most essential feature for determining prices—namely, a system of properly functioning markets. The capitalism which was considered to be failing was an incomplete and frustrated form of capitalism.

THE LEGAL RESPONSIBILITY OF GOVERNMENT TO PROMOTE MAXIMUM EMPLOYMENT AND HIGH-LEVEL PRODUCTION

The close of World War II, in particular, brought growing fears of a business depression and a return to the conditions of mass unemployment

which characterized the great depression. These fears led to a widespread demand for government to assume responsibility for promoting sustained employment. The high level of employment reached during the war period, it was declared, showed that the economic system could be made to operate effectively.

In response to a public demand for "full employment," Congress enacted the Employment Act of 1946. This act declares in Section 2 that

> It is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and coöperation of industry, agriculture, labor, and State and local governments, to coördinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining . . . conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power [1]

In general, it may be said that the Employment Act confers upon the federal government the obligation to use all its powers to promote (1) high and expanding levels of output, (2) reasonably full employment, (3) price stability within the limits necessary to bring about high-level employment, and (4) a strengthening of our system of free and competitive enterprise. The act does not mention any specific means for the government to use in accomplishing these objectives. Instead, the President and Congress are charged with the duty of finding and adopting means which, under the circumstances, appear to be sound. Groups outside of government are also called upon to participate in carrying out the program formulated by the federal government.

The Act provides for a Council of Economic Advisers, composed of three members, which has the tasks of (1) making studies of the current economic situation and (2) preparing recommendations to the President on what needs to be done to promote economic growth and stability. In particular, it is provided that the Council is "to develop and recommend to the President national economic policies to foster and promote free competitive enterprise, to avoid economic fluctuations or to diminish the effects thereof, and to maintain employment, production, and purchasing power." The law states that members of the Council shall be persons "exceptionally qualified to analyze and interpret economic developments." They are appointed by the President and serve at his pleasure.

The Employment Act of 1946 further provides that the President shall transmit to Congress at the beginning of each regular session an *Economic Report*. This report, it is stated, shall (1) describe the economic conditions

[1] 15 U.S.C. 1021. The policy of high-level employment is an essential provision of the United Nations Charter (1945). The Charter provides that the United Nations "shall promote . . . full employment," and declares that "all members pledge themselves to take joint and separate action" for its attainment (Chapter IX, Article 55).

currently prevailing in the United States and (2) present "a program for carrying out the policy declared in . . . [the law], together with such recommendations for legislation as he [the President] may deem necessary or desirable."

Provision is made in the law for the creation of a Joint Economic Committee, to be composed of seven members from the Senate and seven members from the House. The committee is bipartisan and has the functions of (1) making continuing studies on matters pertaining to the *Economic Report* and (2) preparing reports on the main recommendations submitted by the President. The Joint Economic Committee is an advisory body. Its task is to advise Congress on the economic outlook and on proposed economic legislation.

During March of each year the Joint Economic Committee submits to Congress an annual report (*Joint Economic Report*) advising Congress on "the main recommendations made by the President in the *Economic Report*." The Joint Economic Committee also publishes each month *Economic Indicators*, a publication containing charts and tables on prices, employment, wages, business activity, money, credit, and federal finance. This publication, as well as the annual *Joint Economic Report* and the *Economic Report of the President*, can be secured from the Superintendent of Documents.

FISCAL POLICY AS A REMEDY FOR UNEMPLOYMENT

For the most part, the policies which the federal government has used to promote high employment—during the great depression as well as after World War II—have been monetary and fiscal. Impetus for these policies, in particular, was given support by the economic theories of the English economist John Maynard Keynes.

Keynes reasoned that the amount of spending—consumer spending plus private and public investment—determines the level of employment. In his view, the amount that the public tends to spend for consumption out of any given level of income is relatively stable, and the dynamic factor affecting the level of employment is investment. If the rate at which the public (when fully employed) desires to accumulate savings is not offset by actual investment of equal amount, the level of spending will be insufficient to provide full employment and a condition of unemployment develops. Keynes believed that when unemployment develops, government spending should be increased to compensate for the decline in private investment. It follows from the Keynesian analysis that the fiscal policy of government should be directed toward providing a rate of total spending which will maintain a satisfactory level of employment.

Many of the followers of Keynes agree that competition (freedom of entry and price competition) is an essential corollary to an effective policy

for promoting a full utilization of resources. In their view, competition operates to moderate excessive demands, to prevent coercion, and to provide for a proper allocation of resources. They concentrate their attention, however, on the thesis that if savings are not offset by investment, unemployment will follow. Fiscal policy, in their view, is an instrument for creating—or reducing—an aggregate demand for goods and services to provide a satisfactory level of employment, regardless of the degree of monopoly or competition.

THE USE OF MONETARY-FISCAL POLICY TO COMBAT DEPRESSION

In 1933 the Treasury, upon the basis of new legislation enacted by Congress, began manipulating the money supply in an effort to bring about an increase in internal prices. Gold was devaluated, and increased amounts of silver were purchased for monetary use. Large quantities of government bonds were also sold to the commercial banks, and the proceeds were used to finance a government spending program. Following the lead of the Treasury, the central banks adopted an aggressive policy of making credit supplies freely available throughout the country at low rates of interest. Rediscount rates were sharply reduced, and government bonds were purchased in the open market.

In addition to monetary management, government turned to *fiscal policy* for stimulating employment. *Fiscal policy means the purposeful use of public expenditures and taxes to influence the level of employment and business activity*. In utilizing fiscal measures, the federal government undertook large-scale borrowing and spending activities. Budget deficits were incurred; and vast programs of public works, subsidy payments, and make-work schemes were undertaken.

The government financed its expenditures by heavy borrowing from the banking system, for the view of its experts was that deficit financing, in itself, would not help much, if at all, if the government borrowed from the public, because the result might well be to reduce spending by the public. In the plan of deficit financing, government bonds were sold to the commercial banks, and new money in the form of bank deposits was created and added to the monetary supply.[2]

As a result of government borrowings to finance public works and military expenditures, the gross public debt of the federal government rose from some $22 billion in 1933 to nearly $43 billion in 1940 (see Figure 44). Thereafter, with the entrance of the United States into World War II, the national debt increased rapidly and by the close of the war it had reached a total of over $258 billion. Although some of the borrowed funds

[2] "Deficit financing" means government cash disbursement in excess of cash receipts (including cash on hand) which is financed by borrowing.

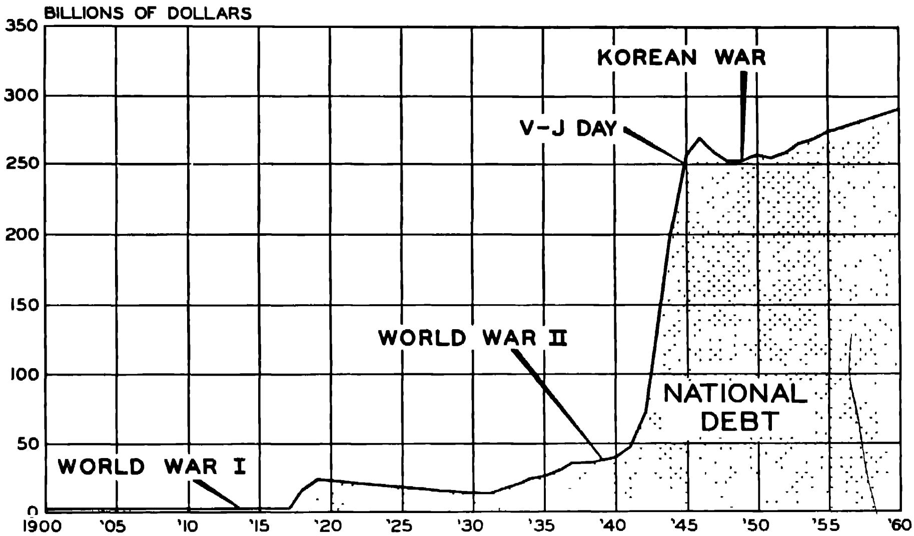

FIGURE 44. Total Gross Public Debt of the Federal Government. The financing, management, and perhaps eventual repayment of the huge debt which arose in consequence of World Wars I and II and depression budgetary deficits present a national problem of major significance. For the future, moreover, the assumption by the federal government of a responsibility for contributing to the maintenance of high employment and high national income promises to make government borrowing and debt management an extremely important factor in the economy. (Sourse of data: United States Treasury Department)

were secured from the savings of individuals, a very large part was secured by the sale of government bonds to the commercial banks and the creation of bank deposits and Federal Reserve notes.

MONOPOLY'S PART IN CAUSING DEPRESSIONS

The business collapse in 1929, as well as successive recessions, have raised these questions: What is the role of monopolistic restrictions in *causing* depressions, and what part do such restrictions play in *aggravating* and *prolonging* depressions? In general, economists agree that the major fluctuations of the business cycle result mainly from fluctuations in investment activity, both public and private; the excessive use of credit; and mass speculation in securities and real estate. Monopolistic restrictions may influence these factors, but they are not a cause of business depressions.

The antitrust laws—and supplementary means for promoting competition—have for their purposes *ends other than the prevention of business fluctuations.* The chief evils of monopoly are long-run (secular), not immediate or catastrophic. They express themselves in an inequitable distribution of income, an uneconomic allocation of resources, a retardation in the reduc-

tion of prices, and restrictions on the investment of capital (see also Table 14, page 133).

Although monopolistic restrictions do not operate to cause depressions, they are probably a significant factor in making them more severe and prolonged. Professor Fritz Machlup, in particular, has emphasized that monopolistic restraints operate to keep excess capacity unused and to aggravate unemployment. In his words,

> We have seen that the steel industry, and many other industries, have gone on for many years with a very large percentage of their productive capacity completely unused, and, instead of making their products available to the market at lower prices, in order to stimulate demand, they have often, in the face of unused capacity, increased their prices, and therefore made the problem of unused capacity a long-run problem, a problem not only of a few months in the business cycle, but a problem of years and years.[3]

Likewise, Professor Howard S. Ellis observes that "monopoly restricts output below the competitive level." His studies lead him to conclude that "monopolistic practices throughout the economic system are a principal cause of unemployment in its massive, recurrent, and persistent occurrence in modern capitalism." To reduce this unemployment, Professor Ellis favors governmental action to improve and extend the competitive price system.[4]

GENERAL ACCEPTANCE OF MONETARY-FISCAL POLICY TO MAINTAIN EMPLOYMENT

There is substantial agreement among economists that a properly planned monetary-fiscal policy makes it possible to avoid extreme fluctuations in prices, output, and employment. Its use during depressions helps to promote full employment by creating and maintaining the total rate of money spending. In providing for reasonable stability *in the price level*, government also promotes the effective functioning of markets and independent enterprise. Inflationary forces stimulate speculative dealings, especially by nonprofessional trade interests, and give rise to extreme price swings and unhealthy boom conditions. A general price deflation, on the other hand, brings the threat of bankruptcy and makes business survival depend more upon large financial resources than upon productive efficiency.

At any given time, the use which is made of particular monetary-fiscal measures depends upon the severity of the unemployment problem. If the volume of unemployment is high, the most effective measure for speedy relief is the creation of deficits through *tax reduction and increased govern-*

[3] *Administered Prices*, Committee on the Judiciary, United States Senate, 86th Congress, first session, 1959, Part 10, p. 4955.

[4] Howard S. Ellis, "Monopoly and Unemployment," in *Post War Economic Studies*, Board of Governors of the Federal Reserve System (Washington, D.C.), 1946, pp. 67–70.

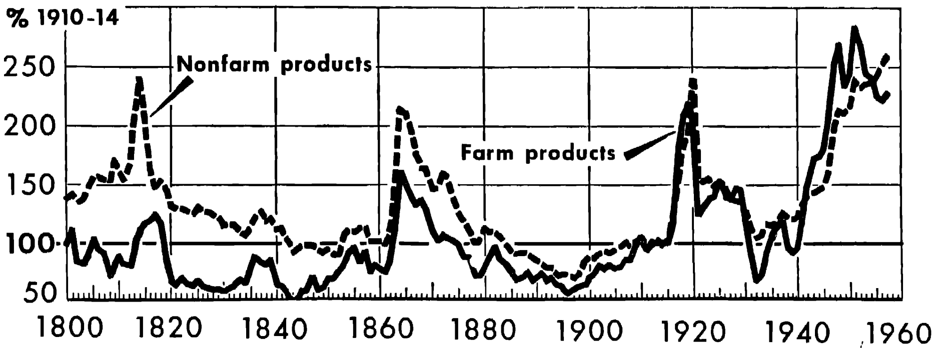

FIGURE 45. Wholesale Prices, Farm and Nonfarm Products, in the United States. Many monetary and fiscal authorities believe that the general price level should probably be stabilized as closely as possible to the level of prices prevailing during the past decade. Deflation, in their opinion, would cause sharp declines in industrial output and employment. (Source: Chase Manhattan Bank, New York)

ment spending. Both of these policies involve a minimum of interference with business enterprise and are politically expedient, for they do not require the taking of any direct action against organized pressure groups in industry, labor, or agriculture.

The consensus of economic opinion on the effectiveness of monetary-fiscal policy in promoting high employment is ably summarized by Professor Martin J. Bailey as follows:

> History has shown repeatedly that the only cure for a drastic fall in aggregate demand is for aggregate demand to rise again; the appropriate public policy for stability and full employment, therefore, consists of countercyclical monetary and fiscal policies, combined with a structure of policy that encourages the private economy to maximum growth and stability. Price flexibility has never been sufficient to avoid sharp and undesirable drops in aggregate output and unemployment, and there is no reason to suppose that such flexibility ever will be sufficient to do so. An adequate countercyclical monetary and fiscal policy has never been put to the test, although the performance of such policy in the recessions of 1937, 1949, and 1954 was not bad. Most economists are agreed that well-formulated monetary and fiscal policy can be sufficient to maintain output and employment.[5]

THE NEED TO SUPPLEMENT MONETARY-FISCAL POLICY IN COMBATING PERSISTENT UNEMPLOYMENT

In competitive industries, we have seen, prices adjust downward with declining demands, to provide a selling outlet for available supplies. Monop-

[5] Martin J. Bailey, "Administered Prices in the American Economy," *Economic Stability and Growth*, Joint Economic Committee, March 31, 1958, p. 101.

olistic (or oligopolistic) industries, on the other hand, typically peg their prices. This action prevents a clearing of the market and keeps excess capacity unused. It is an action, moreover, which has secular and long-lasting consequences.

When producers in concentrated industries cannot sell all the goods which they can or do produce, they commonly cry "overproduction" and call for public spending programs. Government, in other words, is called upon to make it possible for producers of steel, copper, lead, and so forth to sell all that they would like to produce at the prices they would like to get! This, it appears is an impossible burden for government to assume.

In view of the tendency of monopolistic restrictions to prevent a full utilization of productive capacity, it appears that additional measures will need to be taken to supplement monetary-fiscal policy. These measures consist essentially of the antitrust laws. Their application should be designed to reduce concentrated economic power which makes it possible to manage price and to fix a price at rigid levels over a period of weeks or months, regardless of changes in demand.

LIMITATION IN FISCAL POLICY FOR COMBATING INFLATION

Monetary-fiscal policy, we have observed, seeks to achieve price stability by increasing—or reducing—aggregate demand. The level of employment and plant utilization, it is reasoned, depends upon the level of aggregate demand for goods.

In our present-day economy, operating at or close to full capacity and employment, a particular problem of inflation appears to exist in the concentrated industries which possess private discretionary power over price. If fiscal action is taken to reduce aggregate demand to combat *this inflation,* the effect will extend over the entire economy and operate to cut back output and employment, generally. This result is clearly not desirable. Thus, it is reasoned by various economists, monetary-fiscal policy does not provide a useful or practical remedy for the inflation which occurs in concentrated industries at or near full employment.

Professor John Kenneth Galbraith, in particular, has questioned the adequacy of monetary-fiscal policy in controlling the inflation which develops in concentrated industries at or near full capacity. In his words,

> Now we come to monetary and fiscal policy which do not make contact with present forms of inflation, at least in a useful or practical way.
>
> The administered price sector can advance its prices and does whenever the economy is close to full capacity and employment. We have seen that the level of use of capacity and the level of employment depends on the level of demand for goods. Both monetary policy and fiscal policy make contact with this problem by reducing the level of demand. To be effective,

they must reduce, therefore, the level of demand enough to create idle capacity and unemployment since the inflation occurs when idleness and unemployment are not present in substantial amount. . . .

Now, the position so far is this: At or near full employment, we shall have inflation in the concentrated industries. Monetary and fiscal policy can be a remedy only by severely cutting back output and employment, and this remedy is worse than the disease.[6]

Professor Galbraith, as well as many other economists, believes that the use of the antitrust laws to break up large corporate mergers is an inappropriate remedy for combating the inflation in concentrated industries. Professor Galbraith states:

The antitrust laws serve a valuable purpose in our economy. They bring the conscience of the community to bear on the problem of economic power. For this reason they restrain the strong firm in its relation with its weaker competitors, or its suppliers, or its customers. It is for this reason that they have always had a strong claim on the interest of men of moral sense. The antitrust laws could be stronger and better enforced than they are.

But to suppose that the antitrust laws will work the kind of revolution which will reconcile full employment with price stability is out of the question. This would mean a wholesale revision in industrial structure—a wholesale disintegration of existing business units. Even though desirable, there is not the slightest indication from the legal history that the antitrust laws are the instrument for such a revolution. . . .

So I would conclude—and this I would argue with considerable vigor—that there is no hope for an inflation remedy in the antitrust laws. To argue that there is may be to engender doubts about the effectiveness of the antitrust laws for the other very important purposes which they serve.[7]

As a means for controlling the price inflation which develops in concentrated industries, a number of economists propose that all price and wage increases in steel and other basic industries be subjected to some form of federal fact finding. Proposed increases, it would be provided, must be announced in advance of their effective date. After studies made by a fact-finding board, the President would be authorized to declare "that a price and/or wage increase was contrary to the public interest." With such a finding, the increase would be deferred for a period of sixty days. During this interval, it would be possible for an aroused public opinion to come into play (see also Chapter 6, pages 118–120).[8]

[6] *Administered Prices,* Committee on the Judiciary, United States Senate, 86th Congress, first session, 1959, Part 10, pp. 4928–4929.

[7] *Ibid.,* pp. 4929–4930.

[8] This proposal was advanced by Professors J. K. Galbraith, Gerhard Colm, William Haber, Richard A. Lester, Richard A. Musgrave, Robert R. Nathan, and Daniel Fusfeld, in a special memorandum to Governor G. Mennen Williams of Michigan (*New York Times,* July 20, 1959). It has also been presented in Congressional hearings (see *Administered Prices,* Committee on the Judiciary, United States Senate, 86th Congress, first session, 1959, Parts 9 and 10).

In a survey of professional economic opinion conducted by the Joint Economic Committee in 1959, it was found that between 40 and 50 percent of the economists interviewed or surveyed concurred in the need for some form of price and wage control to combat inflation.[9]

THE CONCEPT OF FULL EMPLOYMENT

The Employment Act of 1946, it may be noted, does not define the objective of "maximum employment." From the standpoint of economic analysis, what meaning can be given to the term? Sir William Beveridge, an English advocate of full employment policies, takes the position that "full employment" means "having always more vacant jobs than unemployed men." In his view, "Full employment, in any real sense, means that unemployment in the individual case need not last for a length of time exceeding that which can be covered by unemployment insurance. . . . Those who lose jobs must be able to find new jobs at fair wages within their capacity, without delay."[10] Similarly, Bent Hansen, a Danish economist, defines full employment as a situation in which "the individual worker always sells that quantity of labour he wishes to sell and expects to sell."[11]

Full employment, in brief, is a condition in which all persons desiring work at the going rates for their skill and ability can find it without considerable delay. When workers cannot sell all the services they desire and expect to sell, there is unemployment; and the advocates of full employment believe that this condition should be remedied at once by some sort of government intervention.

It may be noted that in discussions of full employment, there is rarely if ever any mention made of the adjustment of wages downwards to stimulate the demand for labor. The general view is that in a monopolistic economy product prices are rigid and sticky during a recessionary period and that wage rates should accordingly be maintained, or even increased, in order to maintain consumer spending.

SOME CONSEQUENCES OF FULL EMPLOYMENT POLICIES

Following World War II and the subsequent period of rearmament for defense, the strong demands for consumer goods, capital equipment, and military supplies gave rise in many western nations to sustained periods of

[9] *Economic Policy Questionnaire*, Joint Economic Committee, 85th Congress, second session, 1959, p. 4.

[10] William H. Beveridge, *Full Employment in a Free Society* (New York, 1945), pp. 18–20.

[11] Bent Hansen, *The Theory of Inflation* (London, 1951), p. 33.

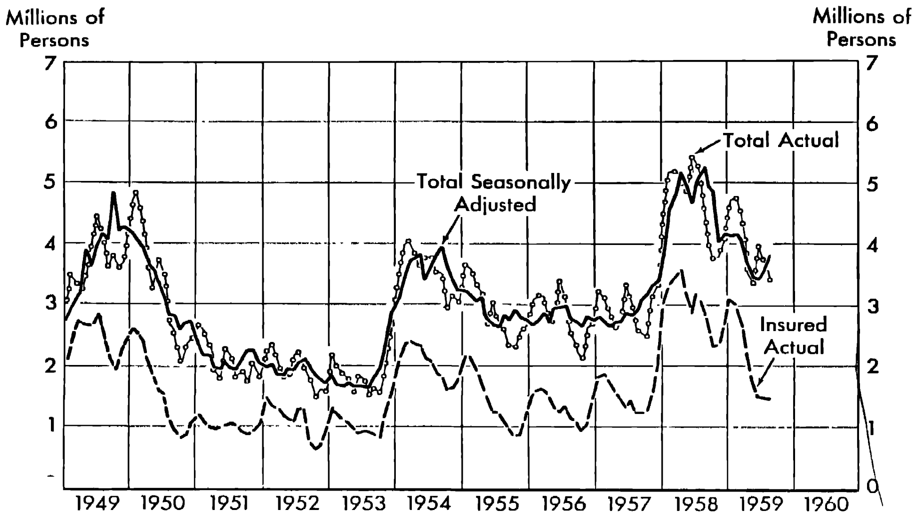

FIGURE 46. Estimates of Total Unemployment. Special antidepression measures, some economists believe, should be adopted by the government when unemployment reaches 2,500,000. Others place the level at 5,000,000. A "normal" amount of unemployment is accepted on the ground that it reflects seasonal factors, temporary layoffs, and a general switching from one job to another. Too much "full employment," it is believed, promotes inflationary wage increases, excessive absenteeism, and unwarranted job switching. (Source of data: United States Department of Commerce, Bureau of the Census)

full employment. With full employment, however, there developed many curious and uneconomic consequences. Various studies indicate that in a period of "full employment" there occurs (1) an increase in absenteeism, (2) a greater amount of declared sickness, (3) an increase in labor turnover, (4) a higher rate of accidents resulting from the employment of workers having inferior mental and physical dexterity, (5) a shifting of workers away from "dirty" jobs, and (6) a persistent tendency toward wage and price inflation. A larger total employment, it has been found, may actually result in a very small increase in total output or in no increase at all. Employment can be "too high" as well as "too low."

The principal economic problem arising in a full-employment program is the consequence of a tendency towards price and wage inflation. Public spending programs to fight depressions usually involve "deficit financing" (cash disbursements in excess of cash receipts) and the creation of new supplies of money. Demand is bolstered, and the drop in prices is checked. Gradually, over time, the policies of public works, cheap credit, and deficit spending may cause an upward pressure on prices, particularly if they are continued after the need subsides.

With the strengthening of demand, various industry groups act in concert to raise product prices. Labor unions, moreover, make periodic demands for higher wages. Since the fear of unemployment is largely

removed, wage demands are pressed aggressively; and it is likely that wages and insurance benefits will rise more rapidly than technological progress. Many employers voluntarily raise wages in order to hold existing workers and to recruit new ones, for they know that in a period of high demand they can easily add new wage costs to their selling prices. Liberal wage concessions are also made to avoid strikes.

Higher labor and raw material costs create a need for larger loans at the banks. The credit authorities (the Federal Reserve Board and the Treasury) are thereupon placed under a compulsion to expand the money supply to support the level of employment at the higher plateau of costs and prices. Restrictive credit policies decrease employment and production; and the political officials, experience has shown, are not willing to choose this alternative. Since it is likely that the money supply will be increased to permit a high level of employment, a continuous rise in prices over the long run is to be expected.

Professor Sumner H. Slichter has observed: "It is high time that the public understand that . . . we can have maximum employment only at the cost of some long-run rise in the price level. Perhaps advances in economic knowledge or changes in institutions will eventually enable us to escape this dilemma, but that day has not yet arrived."[12]

In a similar vein, Professor Milton Friedman declares:

> I am myself of the opinion that we are highly likely to have substantial rises in the general price level in the next decade or so. . . .
>
> In the present political atmosphere, lapses from full employment arouse far more public opposition than price rises and it is widely accepted that government can produce full employment and has a responsibility to do so. Given such an atmosphere, any faltering in the pace of economic activity produces an almost irresistible demand for vigorous counter-cyclical measures. Some such measures—of monetary expansion, increase in governmental expenditure programs, reduction in taxes, favoring of particular sectors such as housing, and the like—are bound to be taken. If these measures had their effects instantaneously and could be shut off like water in a tap, all would be well. Once a contraction was over, they would be so shut off.
>
> In fact, such measures inevitably operate with a lag, in some cases a long lag, and cannot even be shut off without a long lag. In consequence, there is a strong tendency to over-react. . . . The result is an inflationary hang-

[12] *The Journal of Commerce*, New York, September 2, 1952. In a subsequent study, Professor Slichter states: "One of the frequent results of technological research is the creation of good opportunities for profit. But large profits encourage trade unions to make ambitious wage demands. . . . In the 10-year period 1948 to 1958 average hourly earnings of all workers in private industry rose almost twice as much as real output per man-hour. In a consolidated income statement for all American industry, wages and salaries are two-thirds of all costs—twice as important as all other costs combined. When this element in cost rises year after year twice as fast as real product per man-hour, an upward creep in the price level is obviously inevitable (*London Financial Times*, June 8, 1959).

over and upward pressure on prices long after the contraction is finished. Of course, this in turn may produce an over-reaction in a deflationary direction. But I think it will be generally accepted that . . . expansionary measures are likely to be overdone to a much greater extent than contractionary measures. The result is likely to be a generally rising price level, occurring intermittently as a reaction to the recessions that punctuate the period.[13]

THE GREATER RESISTANCE OF THE AMERICAN ECONOMY TO DEPRESSION

The adoption of various antidepression measures following the great depression, it is believed, will likely prevent the recurrence of any serious or prolonged depression. These measures include (1) the Employment Act of 1946 and the present-day use of monetary and fiscal measures to promote and maintain high-level employment, (2) a widespread social security program which serves to maintain consumer demand, (3) an agricultural price-support program which will probably prevent any serious decline in agricultural prices, (4) a system of insurance for deposits in banks and savings and loan associations, and (5) a more stable flow of American loans and financial aid to foreign nations.

The greater resistance of the American economy to depression does not mean that there will be no periods of recession or unemployment—that would be a utopian dream. Business activity is still subject to booms arising from the excesses of credit and speculative investment. Dr. Arthur F. Burns, reporting on our knowledge of business cycles, concludes:

The only things we can be reasonably certain of in the proximate future are, first, that our economic system will continue to generate cyclical tendencies; second, that the government will at some stage intervene to check their course. . . . Our limited experience with contracyclical policy does not provide strong support for the belief, so often expressed by theoretical writers, that the government is capable of adjusting its spending, taxing, and regulatory policies with the fine precision and promptness needed to assure virtually full employment and a virtually stable price level at all times.[14]

THE DILEMMA IN GOVERNMENTAL POLICY

We have indicated reasons for believing that a policy of maintaining high-level employment is inherently inflationary. The chief objection to

[13] Milton Friedman, "Wage-Push Inflation," *Industrial Relations Research Association, Papers,* December, 1958, pp. 214–215.

[14] Arthur F. Burns, *Business Cycle Research and the Needs of Our Times* (New York, 1953), pp. 8–9.

inflation is that it reduces, to the advantage of favored groups, the real incomes of a large part of the population. Debtors, private and corporate, gain from rising prices, for inflation diminishes the burden of repaying their loans. Inflation also places a premium on speculation, property ownership, and manipulation, for dollar incomes in such activities usually rise rapidly and provide extra claims for available goods. An important segment of the population, however, typically finds that its income rises less rapidly than prices. Those who suffer especially include pensioners, holders of fixed-interest securities, government employees, creditors, persons having savings

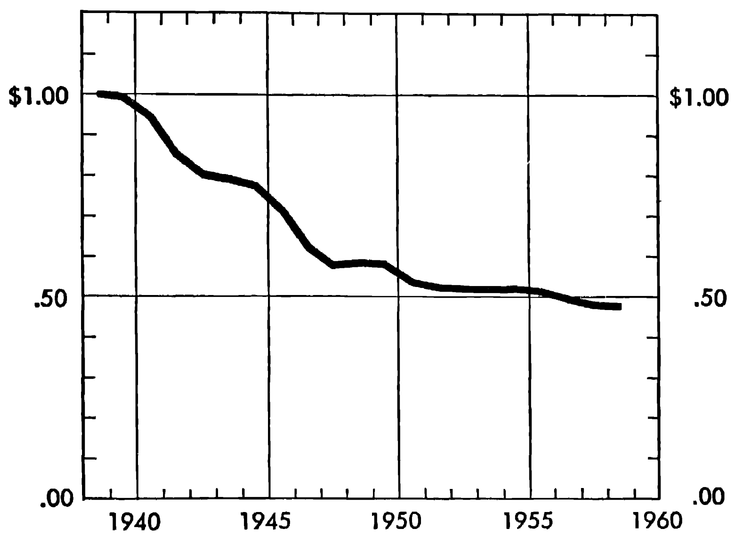

FIGURE 47. Value of the Dollar in Terms of 1939 Consumer Prices. (Source: Bureau of Labor Statistics and Federal Reserve Bank, St. Louis)

and insurance, salaried workers, and wage earners whose bargaining power is relatively weak. Some of these groups are injured much more than others, because of variations in the extent to which their incomes are fixed, or nearly fixed, in money terms.

With the spread of inflation, class conflicts grow; and wage disputes become sharper and more bitter. Many persons become disillusioned with the virtues of hard work, increased productivity, and the development of personal skills. Those who have been able to accumulate government bonds, savings, life insurance, and retirement annuities discover that the value of their savings is frittered away by rising prices. All of such groups provide a reservoir of discontent which may give rise to unwise measures of social reform. Sound public policy thus demands that effective controls be adopted to curb inflation and to provide for price-level stability.

THE NEED FOR A UNITED POLICY TO PROMOTE HIGH-LEVEL EMPLOYMENT AND OUTPUT

In fulfilling the legal obligation to promote high-level employment, governmental authorities have come to place major reliance upon monetary-fiscal measures. These measures, it is generally agreed, make it possible to provide the economy with a greater resistance to severe depressions.

Monetary-fiscal measures, it appears, can be utilized most effectively *when there is a system of properly functioning markets to determine prices.* When monopolistic restrictions permeate important sectors of the economy, restricted investment and restricted output serve to prevent full utilization of capacity. It is here that an improved program of antitrust law enforcement is needed.

Also, when monopolistic restrictions provide large business units with discretionary control over price, there is a tendency for substantial price increases to be made during periods of high employment. Monetary-fiscal policy, we have seen, does not provide a useful or practical remedy for this kind of present-day inflation. As a supplementary measure, a number of economists believe that the government should adopt some form of direct price and wage control.

The Employment Act of 1946 provides, either directly or by implication, for the objectives of maximum employment, economic growth, and stability. The problem is, what measures should be adopted to achieve the desired ends?

In a special study on employment and orderly economic growth, a panel of seven leading economists concluded:

> At the present time our country has no adequate federal policy to promote economic growth and stability and no meaningful anti-inflationary policy. It is a rudderless ship drifting on what is at the moment a rising tide of economic activity. Without a firm policy we will descend again into the trough of economic stagnation and retrogression.
>
> We reject the notion that that government governs best which governs least. The federal government is our only instrument for guiding the economic destiny of the country.[15]

The trend in economic thinking is thus toward greater governmental responsibility for promoting high-level employment, economic growth, and stability. For this task, it appears that the federal government will need to utilize not only the tools of monetary-fiscal policy, but also those of the antitrust laws and, in some degree, direct price and wage controls.

[15] *New York Times*, July 20, 1959. The names of these economists are listed above in footnote 8.

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[15] *New York Times,* July 20, 1959. The names of these economists are listed above in footnote 8.

Suggestions for Further Reading

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24

Basic Problems in Government Regulation of Business

In concluding our study of the many ways in which business is shaped and directed by government, we come face to face with three basic issues. They are (1) the question of the optimum amount of government in business, (2) the problem of dominant economic power with anticompetitive effects, and (3) the task of attaining of sound measures of intervention in the light of pressure politics.

HOW MUCH GOVERNMENT?

What is the optimum amount of government intervention in business? A large amount of historical experience points, on the one hand, to the fallacy of "the law of the jungle"—that is, business rivalry which admits no rules of fair play and in which only the strongest and most ruthless survive. When profit-seeking activities are conducted without rules of the game, they invariably lead to all sorts of monopolistic devices to exclude competitors, curb production, and enhance prices charged consumers.

On the other hand, there is a growing amount of evidence which points to the futility of the "law of the jail"—namely, widespread authoritarian control with restrictions on free choice and initiative and with a multitude of regulations which invite evasion and disregard for the law. Too much government means a stifling of individual enterprise with its emphasis on efficiency, economy, vigorous selling, and imaginative planning. Too much government also carries with it the evils of centralized administration (bureaucracy). These include (1) an unresponsiveness of employees in dealing with the public, (2) cumbersome and irritating rules, and (3) the tendency of bureau chiefs to spend time in expanding their own importance. Finally, substantial intervention in the form of direct control over prices, wages, and output provides a means and a temptation for private groups to influence governmental policy in their own behalf.

In some sectors of the economy, the federal and state governments have adopted commission control or public ownership in an effort to secure fair prices and incomes and to aid in developing economic resources. It is possible that in some areas public ownership will be extended in the years ahead. In other sectors, experience indicates that regulated competition can be made a workable method of directing production and determining prices and incomes, if ample appropriations and an intelligent administration of the antitrust laws are provided. Our experience with antitrust law enforcement shows that the policy of maintaining price competition and freedom of entry requires much more government intervention than Congress and the courts have thought to be necessary. The alternative of public price and output control by commissions, however, requires an even greater application of government to business.

What the optimum adjustment of government to business is—or should be—will vary from time to time and from industry to industry as conditions change and emergent needs arise. As in the recipe of an experienced cook, there should be "enough and not too much." Government is an indispensable instrument to use in providing economic abundance and fair shares of income. Its use, however, should be kept to the minimum necessary to achieve well-being, in order to insure the fullest possible amount of personal liberty.

REASONS FOR THE INCREASE IN GOVERNMENT INTERVENTION

At the present time, large corporate mergers, frequently with considerable degrees of monopoly power, control a substantial amount of the output in the principal fields of business. This condition—directly and indirectly—has called forth a greatly increased application of government to business. Regulatory commissions have been established for many areas in which monopoly has been accepted. Minimum wages, "parity" prices, and enforced collective bargaining, moreover, have been extended to lines of activity disadvantaged by monopolistic control in other segments of industry. Management of prices to enhance incomes usually involves curbing production; and artificial restraints on production have been an important factor in the rise of unemployment which persists year after year. The problem of persistent (chronic) unemployment, in turn, has brought forth a need for further applications of government to business.

Many people are dismayed and alarmed by the growing intervention of government in business. It is a trend, however, which will probably grow in the years ahead. A few hundred corporations largely dominate the various industries. The leading corporations, moreover, are getting larger through acquisitions, the creation of subsidiaries, and the building of branch plants. Economic concentration and private discretionary control over price now call for new forms of government intervention.

Until the problem of concentrated control with private discretionary power over price is solved, there appears to be little probability that intervention in other fields will be lessened. Over the past fifty years, tariffs, mergers, and pricing formulas have enabled organized industry to rise on the teeter-totter in relation to agriculture, labor, and small business. The purpose of government intervention in these fields has largely been to create an approximate balance. Unless all groups slide off the teeter-totter somewhat simultaneously, it is likely that government will have the continuing task of trying to keep them all in balance.

PREVALENCE OF MONOPOLY POWER

Many people continue to look upon and describe our present system of price and output determination in industry as a "free-market" economy. "Markets," it is said, are buyers and sellers; and "market prices" are simply prices on which buyers and sellers "get together." The fact, moreover, that there are several sellers actively soliciting a customer's business, even though at identical delivered prices, is said to provide "competitive" market prices. Such descriptions of "markets," "market prices," and "competitive market prices," we have seen in the course of our present study, are incomplete and inaccurate concepts.

In a study of industrial prices, Dr. Edwin G. Nourse and H. B. Drury conclude that in important areas the pricing of our industrial products is no longer accomplished in the process of sale by "the unseen hand." No longer is it true that "the market is the birthplace of prices." Instead, "the office of the industrial executive has now become the center of significant action." Today, an executive "sets a price objective and directs a controlled productive mechanism toward attainment of that price level." Thereupon, "If goods do not sell at this price, two courses are open. One is to intensify promotional effort. This in essence means stimulating demand, a procedure which itself adds further to costs and works only within the limits set by consumers' purchasing power. The other is to curtail supply."[1]

Other authorities, including Edward H. Chamberlin, C. D. Edwards, George Stigler, and G. W. Stocking, point out that when a small group of sellers make up an industry, coordination and, in fact, concert of action are not only possible but expected, even though the course of action rests only upon quasi understandings. Large firms may be capable of holding small business units in line by punishing violators economically, chiefly by discriminatory pricing and by refusing to sell essential supplies. If the small business firms recognize this probability and go along, the result is noncompetitive price fixing. In each of these instances, the present antitrust laws

[1] Edwin G. Nourse and H. B. Drury, *Industrial Price Policies and Economic Progress* (Washington, 1938), p. 256.

do not afford much opportunity of relief for the public interest or for the small business firms.

THE PROBLEM OF DOMINANT ECONOMIC POWER

The existence of dominant economic power in important segments of the industrial field raises the question of appropriate public policy. Experience has shown that a policy of "self-government" for business cannot be relied upon to provide economic expansion, high employment, and fair incomes. The fact of concentrated power itself, moreover, is unacceptable, because of the restraints it imposes on prices and production. The American public wants freedom to follow an occupation or trade of its own choice, as well as effective, straight price competition in the determination of prices.

Basically, there are two choices for the public to make with respect to dominant economic power. They are (1) to cut concentrated power or (2) to control its behavior.

The danger in accepting concentrated power and seeking to control its behavior is the real possibility that we shall succumb to centralized economic power. The very fact of competition itself helps to offset and diffuse the power of business groups to determine prices to their own advantage. Each competitor helps to moderate the excessive demands of others. When this moderating influence is removed and the power of business is concentrated in unified control, experience indicates that it is exceedingly difficult for democratic government to prevent organized groups from getting essentially what they want.

In considering the Public Utility Holding Company Act of 1935, the President and Congress faced up to the problem of whether or not to accept the then vast holding company combinations in the electric and natural gas fields. The giant holding company system, President Roosevelt and his advisers believed, not only failed to perform a demonstrably useful purpose *but also served to make effective regulation impossible.* In the words of President Roosevelt, "It is idle to talk of the continuation of holding companies on the assumption that regulation can protect the public against them. Regulation has small chance of ultimate success against the kind of concentrated wealth and economic power which holding companies have shown the ability to acquire in the utility field. No Government effort can be expected to carry out effective, continuous, and intricate regulation of the kind of private empires within the Nation which the holding company device has proved capable of creating."[2]

The history of fascism in Italy and Germany indicates that if economic concentration is permitted to grow unrestrained, it is likely to result in autocratic control by an oligarchy of big business. Jack London, in his

[2] *The Public Papers and Addresses of Franklin D. Roosevelt* (New York, 1938), Vol. 4, p. 100.

book *The Iron Heel,* developed the picture of a tyranny lasting for many centuries exercised by an organized industrial plutocracy. This, he believed, was likely to be the next stage in political change.

Conservative economic opinion points to the need for reducing dominant economic power rather than accepting it. This task of cutting down power is clearly one which cannot be accomplished in a short period. Several generations of time may be required. The important thing is the *direction* in which we move.

Until significant action can be taken in the concentrated industries to reduce private power over production and prices, it appears likely that it will be necessary to control behavior. Price discrimination and refusals to sell, for example, flow from monopoly power. Neither one of these trouble-some commercial practices ordinarily arises in a competitive market. Public policy can be centered on creating competitive conditions without regard to controlling behavior. The danger in this course of action, however, is that without a curbing of discriminatory practices, small and medium-sized business firms are not likely to survive to play a part in the restoration or creation of competition.

The task with respect to concentrated control is twofold. First, there is a continuing need to move in the direction of reducing economic power which gives discretionary control over production and prices. Secondly, there is the equally important need to curb the anticompetitive behavior of presently existing concentrated power in order to preserve and encourage small business.

THE NEED TO FORMULATE A NATIONAL POLICY ON CORPORATE CONCENTRATION

In large measure the economic problem of monopoly in the United States centers around the several large companies (the "Big Threes" and the "Big Fours") which have become dominant in the various industrial fields. It is in this area that the antitrust laws have not been applied to remedy the problems of price leadership and unified selling practiced allegedly without agreement.

The passage of the Antimerger Act of 1950 indicates that there is a considerable public opinion agitated for action against the continuing rise in concentration of economic power. Gradually, the public and Congress may come to realize that if it is detrimental to our economic health to permit new cencentration—as illustrated by the Bethlehem-Youngstown decision (1958)—it is also detrimental to permit those few which have grown too big to be frozen in their present position of dominance.

The development of a standard for the percentage of production or sales which a concern may be permitted to control is one of the vital tasks in present-day antimonopoly work. The standard need not contemplate the

so-called atomization of industry. Crossroad forges need not be substituted for modern steel plants. It is clear that the American economic system must be made to accommodate itself to the largest *physical* plants that are necessitated by the existing or any future technology.

PUBLIC POLICY AND THE GROWTH OF MONOPOLY AND SPECIAL PRIVILEGE

During our history as a nation, the relations of government to business have been a strange mixture of (1) policies designed to promote the common interest and (2) grants of special favor to organized interest groups. Few people realize the extent to which business groups (including labor and farm groups) have gone into politics to secure special economic privileges in an effort to increase their share of the national income and their control over public policy.

The process of granting special favors began with tariffs. Then special advantages were secured by commercial groups in the disposal of the public domain. Within a few decades large railroad, mining, lumber, and other corporations secured much of the nation's finest mineral, forest, and agricultural land either as a gift or for a nominal price. As a result of a deliberate change in our statute laws, corporations secured the right to acquire and vote the stock of other corporations. Thereupon, the corporation, as a creation of government, became the most effective method for securing monopoly control which has ever been devised.

Although the antitrust laws were enacted to curb monopoly in all fields of business, exemptions have been granted by Congress to producers in many important areas. The federal courts, too, following a fallacious notion of laissez faire, have given approval to the formation of giant mergers and to the right of corporations to sell if they please, when they please, and to whom they please.

With the impact of the great depression, organized labor and farm groups were able to secure special legislation to enhance their incomes. In granting this legislation, government itself undertook to give favors to agriculture and to labor, in part, at least, to offset the monopolistic (or restrictive) power of industry.

Robert M. Hutchins characterizes American democracy as "the pressure group state, which cares for the welfare of those who are well enough organized to put on the pressure." In his appraisal of American democracy, Mr. Hutchins states that today the main thought is not to get rid of special privileges, but rather to extend them. He observes:

> Is the tariff hurting the farmers? Retain the tariff and subsidize the farmers. Are administered prices hurting labor? Let's have administered wages, too. Is industry demoralized by expense accounts and tax dodges? Let's have featherbedding in labor, too. Is something done by some group anti-social?

Let's all of us—all of us who can put on the pressure—be anti-social, too. And if a federal agency is established to regulate us, never fear: we have the pressure that will shortly make the agency the servant and mouthpiece of the interests it was intended to control. And as we laughingly count our gains at the expense of the public, we can reverently repeat the solemn incantation that helped to make them possible: that government is best which governs least.[3]

The growth of our present-day pressure-group state, unless checked, Mr. Hutchins believes, is certain to put our institutions and faith in democracy to the test of survival. "Our object today," he concludes, "should not be to weaken government in competition with other centers of power, but rather to strengthen it as the agency charged with the responsibility for the common good."

PLANNING FOR ECONOMIC ABUNDANCE AND INDIVIDUAL FREEDOM

The maintenance of a system of private property, free initiative, and competitive enterprise will require vigorous and far-reaching measures of intervention to break and dissipate private monopoly power. This action will not be easy, for in taking it government will have to step on some toes.

Remedies Proposed

Federal Charters with Strictly Limited Powers for All Corporations Engaging in Interstate Commerce. Important obstacles to the attainment of a fully competitive economy are to be found in the gaps, vagaries, and laxity of present-day corporation laws. Although we now have a national economy, we largely leave to fifty charter-granting states the prescription of rules and standards for the organization and internal government of interstate business units. Rivalries for fees have made it impossible for most states to adopt and enforce rules and standards in the public interest. There is substantial agreement among economists and legal experts that the remedy for this condition is (1) the adoption of federal incorporation or licensing legislation for all corporations engaging in interstate commerce and (2) the formulation of rules and standards for corporate size and behavior which will remedy recognized evils (see Chapter 17, pages 381–386).

As soon as the rights and duties of corporations are carefully defined, business regulations will, in considerable degree be self-enforcing. Stockholders will have clear ideas of their rights against management, and the public will know the standard of performance which corporate managements are pledged to render. The self-interest of majority and minority

[3] Robert M. Hutchins, "Is Democracy Possible?" *Bulletin, The Fund for the Republic,* February 1959, p. 7.

stockholders, as well as the general public, in pursuing their individual rights and claims will thus be enlisted to see that corporate managements comply with federal rules and standards.

A Basic Antitrust Program. If the Department of Justice and the Federal Trade Commission are to make their contribution to the creation of a competitive economy, it will be necessary for them to fulfill certain standards of accomplishment. Assaults upon monopolistic practices which fall short of these standards will probably prove to be futile. The two antitrust agencies, it is suggested, should include in their programs:

1. *Vigorous enforcement action to eliminate all price fixing which is found to result from any mechanism other than the impersonal forces of demand and supply operating in competitive markets.* Identical bids are mainly arrived at by means of (1) collusive agreement and (2) the uniform use of a certain method of pricing, with the knowledge beforehand that others are doing likewise (concurrent action), so that the natural and foreseeable result is a matching of bids. In the case of *collusive* action, the Sherman Act clearly provides an adequate remedy. When specific evidence on collusion is not available, however, it appears that the Federal Trade Commission Act (Section 5) can provide a practical remedy for concurrent action which lessens competition. This legislation, in particular, was enacted by Congress to enjoin any act or practice which lessens competition *regardless of combination, agreement, or conspiracy among sellers.*

2. *The enactment of legislation amending Section 2 of the Robinson-Patman Act to restrain price discriminations which injure or destroy competition.*

3. *A consistent, determined program to halt further concentration of economic power.* Full use should be made of Section 7 of the Clayton Act, to condemn acquisitions in any given market whenever a large company having a substantial share of the sales in that market acquires another company in that market, regardless of possible justification by the rule of reason.

4. *The initiation of carefully planned cases to break up existing concentrations of economic power.* Corporate giants which have already grown too big should be reorganized to meet the same standard on size which is imposed for new growth. The formulation of an appropriate standard for size may require the adoption of additional legislation by Congress. One proposal is that the Sherman Act be amended to provide that a *prima facie* case shall exist against any concern which controls more than a specified percentage of the production or sales of a given product, or related group of products, *in its area of practical shipment.* Concerns seeking to control more than the specified limit (for example 20 percent) would be forced to bear the burden of proof in rebutting the presumption of illegal size. If they could demonstrate that such a degree of concentration was in the public interest, they could be permitted to retain their existing control of production or sales. However, if not, the size of the company could be

reduced, and the right to expand by acquisition or by building branch plants could be denied.

Further Measures for Strengthening a Policy of Competition. Additional measures which, it is believed, are essential for the maintenance and preservation of a system of free enterprise include the following:

1. A requirement that an industrial corporation controlling a substantial percentage of the output of a standard product shall sell at posted prices to all customers offering cash or approved credit.
2. The provision of publicity on prices, sales, and supplies of the basic industrial commodities by some quasi-public organization—such as a commodity exchange—or by the government itself.
3. The reduction of restrictive tariffs in order to promote domestic abundance and to achieve a more balanced world economy.
4. An informed and purposeful use of monetary and fiscal policies to aid in stabilizing income and employment levels.
5. A continuing effort by officials in defense agencies, as well as by Congress itself, to spread defense contracts and accelerated amortization privileges equitably among small and large business firms. The nation is largely dependent upon small business for competitive pressures, and it is highly important that small business be given a fair chance to survive upon the basis of its efficiency.
6. The abolition of all special privileges and antitrust exemptions granted to organized business groups which cannot be shown to benefit the consuming public.
7. The provision of rules for trade-union activity by legislative action (in lieu of antitrust prosecution) prohibiting uneconomic and restrictive practices—such as limitations on the use of more efficient methods, materials, and equipment; restrictions on the entry of new firms and products; and the enforcement of illegally established product prices.
8. The requirement of some form of compulsory arbitration in key industries if voluntary arrangements fail.
9. The adoption of sound measures of conservation to prevent physical waste in the use of nonrenewable resources—such as petroleum (oil and gas)—and to provide for the continual renewal of all other resources.

A policy of individual enterprise and price competition is a highly elaborate and complex plan for organizing the conduct of economic activity. It is a plan, moreover, which is not self-enforcing. When the policy of competition is accepted, it must be implemented by positive measures to provide for its creation, maintenance, and preservation. Competition is a form of human behavior; and like other behavior it should be conducted according to good manners and morals. The big mistake which government has made with respect to economic regulation is in thinking that in the absence of direct price control (as in the case of public utilities) government intervention is not necessary. The lessons of history clearly show

that we cannot have fair competition unless positive measures are taken to create and maintain it.

PRACTICAL OBSTACLES IN BUSINESS REGULATION

How is a policy of effective competition to be attained? How are larger appropriations for antitrust law enforcement to be secured? What steps are necessary to secure the adoption of federal incorporation legislation? How can a more effective control be exercised over public utility enterprises? What, in brief, is the starting point in a consistent program of government intervention to promote the common interest?

It is to Congress and the Chief Executive, in the main, that the nation must look for positive leadership in adopting measures to promote the economic welfare of the nation. Typically, congressmen want to do what is right and best for the entire country. However, each one knows that he has little chance to be re-elected if he incurs the displeasure of special interests "back home." Organized minorities and pressure groups—such as the silver bloc, the wool bloc, the tobacco bloc, the coal bloc, the sugar bloc, and the basing-point industry bloc—have funds, newspaper influence, and votes which can be used to defeat a person seeking re-election. As a result, congressmen commonly find themselves swayed and guided by the wishes of the dominant interest groups in their respective constituencies rather than by a regard for the national economic interest.

One must ever bear in mind that democracy operates in an environment of pressure groups. In some cases the measures of regulation themselves have been inadequate. However, in most cases the problem of ineffective public regulation arises from the fact that legislation has been rendered ineffective by the interest groups which it has sought to curb. Here is the crux of the matter.

THE EXPENDITURE OF LAVISH SUMS TO SHAPE PUBLIC POLICY

In the American economy the rise of giant corporations, in particular, worked to concentrate political influence in the hands of a few. From about 1890 to 1907, large corporations were the principal source of funds for the major political parties. In 1907 Congress, under pressure from the public, prohibited corporations from making campaign contributions in the national elections. In 1943 the Smith-Connally "Antistrike" Act extended the prohibition on contributions to labor organizations, and in 1947 this prohibition was re-enacted in the Taft-Hartley Act.

The legal prohibition on corporate contributions has not entirely remedied the problem. In place of direct contributions, officers and directors of

corporations have become generous donors to the national and state committees of the major political parties. In a study of the 1952 election, Professor Alexander Heard found that officers and directors in ninety-two of the largest corporations made political contributions. "It is probable," says Professor Heard, "that if the file were complete, someone from most of the remaining 8 firms would have been there as well."[4]

Corporations also participate directly in politics by advocating political views in radio and newspaper advertisements. They buy whole tables of tickets at high prices for political dinners. They spend millions lobbying in the national conventions. They loan top-level executives to a candidate's campaign headquarters and make contributions to private political organizations. Newspapers, as corporations, also make "contributions of space," having cash value, in editorials supporting particular candidates.

In 1940 Congress made it illegal for any "political committee" to receive more than $3,000,000 in any calendar year and limited the contributions of any person to a national committee to $5000 in any one year. No limit, however, was placed on contributions to state and local committees or to other organizations which work hand in glove with the central committee. Similar loopholes exist for other regulations on campaign contributions and expenditures. Today there are no real limitations on the amount of money which a person can contribute or which a candidate or political committee can spend.

PRESENT-DAY COURSES OF CAMPAIGN FUNDS

Studies made by Professor Louise Overacker show that in recent national elections the Republican party has secured its major support from bankers and manufacturers of iron, steel, autos, trucks, airplanes, food products, chemicals, textiles, cosmetics and drugs, paper, oil, public utilities, and mining. Although the Democrats have also received a substantial support from various banking and industrial interests, it has not been as large as that secured by the Republicans. The Democratic party, in particular, has had the support of public power advocates, contractors, builders, producers of materials for public work programs, organizations of the professional classes, and organized labor.[5]

The election of 1944 was the first in which a prohibition was placed on contributions by labor unions. With a little ingenuity, however, the unions

[4] Alexander Heard, *Money and Politics, Public Affairs Pamphlet 242,* New York, 1956, p. 17. See also his *The Costs of Democracy* (Chapel Hill, 1960).

[5] Professor Louise Overacker has published most of the significant material bearing on this problem. Her studies are based upon a careful examination of reports filed by the Republican and Democratic parties. See *The American Political Science Review,* "Campaign Funds in the Presidential Election of 1936," June, 1937, pp. 473–498; "Campaign Funds in the Presidential Election of 1940," August, 1941, pp. 701–727, "Presidential Campaign Funds, 1944," October, 1945, pp. 899–925.

were able to meet the provisions of the law by organizing political committees which raised money directly from the union members through voluntary contributions.

When one studies the substantial campaign contributions made by those associated with large banks, industrial corporations, and labor organizations, he becomes vividly impressed with the great difficulty which unorganized consumers—citizens generally—face in trying to make their political voice effective. Measures which affect vested interests adversely—such as increased appropriations for antitrust enforcement—stand little chance as long as our political parties are financed by the large interests rather than by the general public.

THE HIGH COST OF POLITICAL CAMPAIGNS

The extensive use of radio, television, special trains, and chartered airplanes in recent campaigns has greatly increased the cost of winning votes. Estimates for the 1952 campaign place the cost to both parties at $140,000,000 and for the 1956 campaign at $155,000,000. Political campaigns, some observers remark, are becoming a contest of wallets rather than ballots.

Why are candidates and their financial supporters willing to spend so much money to win a national election? The conservative *U.S. News and World Report* states as the reason, "The stake is control of a government [which] holds the power to grant or withhold favors of immense value."[6] What are the favors which government can grant or withhold? They include such acts or concessions as tax adjustments, tariff favors, antitrust exemptions, government contracts, oil leases, licenses for power sites, loans, freedom from legal prosecutions, appointments for key positions, and special legislation. Organized producers are particularly interested in securing sympathetic and favorable treatment by the various regulatory agencies. A decision dismissing a complaint or granting a requested price or rate increase may mean millions of dollars to a large corporation or industry group.

INTEREST GROUPS FOCUS ATTENTION ON CONGRESS

After the elections are over, organized groups seek to bring their influence to bear directly upon members of Congress. Their goal is to shape governmental legislation along the lines of their interest. If they should lose in Congress, they appeal to the administrative agencies and then to the courts. If, by chance, they lose again, they not infrequently return to Congress in a final effort to modify the law or policy which limits their gainful activities.

The techniques of influence which interest groups use on members of

[6] *U.S. News and World Report*, October 3, 1952, p. 15.

Congress are numerous. They include direct contacts in offices and committee hearings, entertainment, the granting of loans, and the payment of retaining fees for legal services. Special gifts and financial favors made by known donors, in particular, serve to create a sense of obligation to private interests in the day-to-day functioning of government.

In order to persuade certain congressmen to vote for their measures, interest groups pour propaganda into the districts represented by these congressmen. This is done with the aid of various business groups through newspaper advertisements, radio, and television. Millions of letters are sent out urging people in the critical areas to hear or watch certain programs. Special attention is paid to congressmen who win by 55 percent or less of the popular vote. These men, it is reasoned, are particularly subject to newspaper, radio, and television pressure at the local level.

A well-known Washington correspondent has written that "property has not hesitated to corrupt government when necessary to preserve its precious advantages and to extend them. . . . We take it for granted that the property lobbies will push our legislators around whenever the interests of their principals are threatened."[7] Estes Kefauver, after many years in Congress, has declared: "It would be a startling revelation to many if figures could be obtained showing the actual and proportionate number of important bills drafted originally in the office of some lawyer or trade association."[8] Similarly, Professor D. C. Blaisdell reports: "Much of the general legislation on our statute books is the result, wholly or in part, of group pressures."[9]

THE FOURTH BRANCH OF GOVERNMENT

The influence exerted upon Congress by organized groups has led various writers to designate "pressure groups" as the "fourth branch of government." Strictly speaking, any association of individuals which seeks to secure or prevent specific legislation is a pressure group. Typically, however, pressure groups represent various producer and commercial interests—big business, small business, organized labor, and organized farmers. Within each major group, specialized groups—such as the oil bloc, the silver bloc, the sugar bloc, and the steel bloc—usually have selfish interests of their own, and these interests may lead them to cooperate or to compete with other groups for influence and favor.

Not infrequently the selfish interests of particular groups lead them to sponsor legislation which is in the public interest. Thus, organized exporters seeking to promote sales abroad are the source of cogent and persuasive

[7] Kenneth G. Crawford, *The Pressure Boys* (New York, 1939), pp. ix–x.

[8] Estes Kefauver and Jack Levin, *Twentieth Century Congress* (New York, 1947), p. 156.

[9] *Investigation of Concentration of Economic Power,* Temporary National Economic Committee, Monograph 26, 76th Congress, third session, 1941, p. 57.

arguments for low tariffs. Their *business interest* depends upon the ability of foreign concerns to obtain dollars by selling products within the United States. This point of view coincides with the public interest. Low tariffs promote exchange and specialization, and specialization increases productivity and enhances supplies of enjoyable goods. On the other hand, domestic producers whose products are vulnerable to import competition are the "prime movers" for our policy of restrictionism. What is it that determines whether a policy of low tariffs or high tariffs will prevail?

The congressmen who determine tariff and other public policies in their votes on the relevant laws are influenced by the factors which help to elect them to office. Making use of these factors, special interest groups apply pressure to congressmen (1) by contributing funds to their election campaigns; (2) by promising the support of large blocks of votes—such as the votes of farm and labor groups; (3) by appealing to individuals and groups of voters within a congressman's constituency—through newspaper advertising, radio broadcasts, news releases, and personal letters; and (4) by working directly with members of Congress during legislative sessions.

As in other fields, money is power, and the groups with the most generous resources and the most efficient staffs are the ones most likely to be successful in gaining favorable action in Congress. With plenty of money, long and hard work, and a few experienced contact men (lobbyists), particular business groups can go far in securing what they want.

INTEREST GROUPS AND THE REGULATORY COMMISSIONS

Interest groups not only have a vital concern in the work of Congress and the state legislatures, but also in that of the various regulatory commissions. The commissions are daily engaged in making decisions, and these decisions are of the utmost importance to organized producers.

Very often the legislation defining the duties of a commission is expressed in general terms, and the commission itself is in a position to determine the specific course of action to be taken. The Federal Trade Commission, for example, is charged with the duty of eradicating "unfair methods of competition." This term is not defined, and it is within the discretion of the Commission to proceed against certain business practices and not against others. In most cases, too, a commission does not have enough funds to investigate and prosecute all the complaints before it, so that it is able to select some for prosecution and to reject others.

The commissions often find, moreover, that the statutes under which they operate contain provisions which are conflicting or contradictory. In making laws, Congress and the state legislatures commonly make concessions and compromises in order to secure certain objectives. The resulting legislation includes provisions and qualifications which require years for interpretation

and clarification. The Clayton Act, as amended, for example condemns price discrimination which injures competition. At the same time, it exempts price discrimination made in "good faith" to meet competition. Which provision is to control—injury to competition or a seller's privilege to discriminate to meet competition? As we saw in Chapter 14, pages 318–319, the Federal Trade Commission has been subject to tremendous pressure from large corporations to construe the law to permit discrimination.

In 1948 the Federal Trade Commission secured favorable court decisions upholding its charge that the *concurrent* use of basing-point pricing in the conduit industry was a trade-restraining practice and illegal under Section 5 of the Clayton Act (see Chapter 15, pages 348–349). As a result of industry opposition to this rule of law, however, the Commission has not been willing to initiate additional cases against the concurrent use of pricing formulas, even when the result is identical pricing.

Organized industry groups are continuing to press for a larger use of the "rule of reason" in the enforcement of the antitrust laws. In their view the statutes can and should be construed—administratively and judicially—to fit the business structures and business practices which presently exist. The Sherman Act contains no rule of reason, but the petroleum industry was able to get one written into the law in the Standard Oil decision (1911). So, likewise, the Antimerger Act of 1950 contains no provision stating that it shall be construed in "the light of reason." In applying the statute, however, the Federal Trade Commission has indicated that the rule of reason shall apply (see Chapter 14, pages 326–327). In this, as well as in many other examples, the decisions of the regulatory commissions reflect the values held by interest groups.

Industry groups subject to control by the various utility commissions give their utmost attention to the personnel and policies of these agencies, for the commissions have a wide range of discretion in approving rates. The rates for electricity, gas, telephone, and transportation service, it is provided, shall be "just and reasonable." But what does this phrase mean? Should rates be based upon original cost or upon reproduction cost new? Today, many utility spokesmen are pressing for substantial rate increases and call for emphasis on reproduction values and increased allowances for depreciation. Others believe that industry well-being is to be found in technological advance and load growth.

NECESSARY MEAURES FOR STRENGTHENING DEMOCRACY

It is evident that if government policy is to be turned from considerations of special privilege to those of national well-being, democracy must be strengthened and made to operate more effectively. Everything should be done to make it possible for congressmen to be free from the continuing

demands of organized producers for public grants of special privilege which benefit a few at the expense of many. Adequate salaries and retirement annuities, in particular, should be provided. As a supplemental measure, it has been proposed that the outside earnings and legal fees which many congressmen secure in serving private citizens and corporations be limited to $25,000 per year. Another proposal is that all members of Congress, all federal officials receiving a salary of $10,000 or more, and all major officials of national political parties be required to make annual disclosures of their incomes by source, their assets, and their dealings in assets and securities.

Attention also needs to be given to the regulation of campaign contributions and expenditures. Experience has shown that present-day laws limiting campaign gifts and prohibiting contributions by corporations and labor organizations do not, in fact, prevent substantial gifts by important financial interests and groups. As a result of the many loopholes in existing legislation, there is at present no real limitation on expenditures in national elections.

During the past thirty years, numerous congressional committees have proposed remedial measures for the more serious abuses, but they have not been adopted (see Figure 48). Some of the main recommendations include the following:

1. Total political contributions by any individual should be limited to $5000 (or $10,000) during any one year. This limit should apply to *total* contributions—for primary elections, party conventions, general elections, and postelection debts. Contributions should not be permitted by persons below voting age. Any person giving more than $500 should be required to sign a statement that he is the donor and not the agent of an undisclosed principal.

2. Overall, realistic limitations should be imposed on the expenditures made in behalf of candidates for federal offices by *all* organizations, partisan as well as nonpartisan, whether the committees operate in one state or in more than one state.

3. A limitation should be placed on the editorial space which any one editor or publisher can use in behalf of a candidate.

4. Federal regulation of political contributions and expenditures should cover primary elections for federal offices, political party conventions, national elections, and post-election gifts.

5. Each party and each candidate for federal office should have a *single, authorized agent* who is responsible for the solicitation, collection, expenditure, and reporting of all funds used in all stages of a campaign. *The biggest difficulty in regulating campaign funds is the diffused nature of the expenditures.*

6. Corporations should be further restricted in their use of funds to support political parties or political creeds. Only natural persons should be privileged to participate in state or national elections.

7. The federal government itself should make some provision for financial assistance to political parties. This assistance could provide for the issuance of a publicity pamphlet at public expense on campaign platforms and issues; the granting of a limited amount of free mailing service for all candidates; and the provision of a limited amount of free radio and television time, to be granted by the stations as a condition for a federal license.

FIGURE 48. "You Got Elected, Didn't You?" Congressional committees have long recommended remedial legislation to regulate campaign contributions and expenditures. So far, however, no action has been taken. (From *Herblock's Special for Today* [Simon & Schuster], 1958)

8. The fifty states should take steps to adopt uniform laws regulating campaign expenses for state offices to complement the strengthened federal legislation.

The problem of public policy toward concentrated control must ultimately become a political issue in the United States. Diversity of interests and divisions within each of the two leading parties may prevent either party from taking the problem to the people in a national election. Rather it is

likely that individual candidates in each party will press for changes to preserve private property, free enterprise, and competition. Their efforts and the public support which they receive will determine whether our nation will continue to embrace the American ideal of creating and maintaining competitive institutions.

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